Montana Trust Land

Cabin Site Lease Rate Valuation Analysis

9/16/2011

Report Prepared for: State of Montana Department of Natural Resources & Conservation:
Trust Land Management Division

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BIOECONOMICS

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EXECUTIVE SUMMARY

Setting and Objectives

This report, by Bioeconomics, Inc. of Missoula, Montana, has been prepared under contract number 115380 CSO with the State of Montana Department of Natural Resources and Conservation. The primary task associated with this contract is to:

> [B]e responsible for furnishing DNRC with a report that estimates the statewide full market value rental rate for Montana state cabinsite leases given the terms and characteristics of those leases. The estimated full market value rental rate must be made as a percentage of the appraised value, which is consistent with the method of establishing value described in MCA 77-1-208.

Specifically,

1. Review the current economic literature to identify other recent studies and data sources that may relate to this issue (In addition to the 1993 Duffield and the 2009 DNRC reports). For example information from the state of Idaho related to cabinsites, such as the Knipe and Knipe report, the PERC report, the lessee association's Warren Illi report, the current cabinsite rules ARM 36.25.1001-1013, and other applicable reports. Additional considerations – at a minimum – shall be given to examination of lease rates/lease agreements of privately held land leased for recreational cabinsites in other states, namely sites owned by power companies around reservoirs.

2. Analyze the available series of MT DNRC transaction data for cabin site assignments and sales of leasehold improvements to estimate averages and trends in leasehold values associated with these transactions.

3. Analyze the available series of MT DNRC state cabin lease competitive bid data for averages and trends in the relationships between minimum bids and final winning bids, and what that relationship implies regarding leasehold value and the appropriateness of existing minimum bid levels.

4. Analyze any data made available by DNRC on changes in lease rental rates over time and associated site vacancy rates during the same period. This somewhat exploratory analysis will seek to correlate any quantifiable demand relationship between lease rates and site demand from existing data.

Background, Legal Setting and Legislation

Through the Enabling Act of February 22, 1889, the Congress of the United States gave to the State of Montana two sections of land from every township for common school support. The Enabling and other acts also granted acreage for other educational and state institutions. The original common school grant was for 5,188,000 acres. The additional acreage provided for other endowed institutions included 668,720 acres, for a total of 5,856,720 acres. The total acreage fluctuates through the years due to land sales and acquisitions.

Of the total trust lands in Montana, a relatively small percentage has been managed within a residential recreational lot lease program. Through this program, private parties enter into multi-year leases for platted lots for the purposes of residential and/or recreational use. In exchange for yearly lease fees, they are permitted to construct improvements on the lots, and, should they choose to end the lease at some point, they may sell the improvements to the next lessee (should a deal be struck). For much of the history of the leasing program lease fees are acknowledged to have been below full market value (for example, Illi 2010). In 1999 the Montana Supreme Court ruled that the then current 3.5% annual lease rate was below market value. This ruling was rooted in Article X of the Montana Constitution.

Article X, Section 11, of Montana's Constitution provides that School Trust Lands "shall be held in trust for the people, to be disposed of as hereafter provided, for the respective purposes for which they have been or may be granted, donated, or devised." The Montana Supreme Court has clearly stated the terms of this trust:

> *The grant of lands for school purposes by the federal government to this state constitutes a trust [citations omitted]; and the State Board of Land Commissioners, as the instrumentality created to administer that trust, is bound, upon principles that are elementary, to so administer it as to secure the largest measure of legitimate advantage to the beneficiary of it. Rider v. Cooney, 94 Mont. 295 at 307, 23 P.2d 261 (1933).*

In its 1999 decision (*Montrust v. State of Montana, ex rel. Board of Land Commissioners, 296 Mont. 402, 989 P.2d 800 (1999))*, the Montana Supreme Court cited private trust law authority in striking down a number of statutes that violated the State's duty of undivided loyalty to the beneficiaries and prevented the institutional trust beneficiaries from deriving the full benefit of revenue from trust lands. In describing the State's duty of undivided loyalty, the Court wrote that:

> In *Wild West Motors, Inc. v. Lingle (1986), 224 Mont. 76, 728 P.2d 412*, this Court considered a trustee's duty of undivided loyalty and concluded:
>
> *When a party undertakes the obligation of a trustee to receive money or property for transfer to another, he takes with it the duty of undivided loyalty to the beneficiary of the trust. The undivided loyalty of a trustee is jealously insisted on by the courts which require a standard with a "punctilio of an honor the most sensitive." A trustee must act with the utmost good faith towards the beneficiary, and may not act in his own interest, or in the interest of a third person.*

As a result of the 1999 decision, in 2000 the Land Board adopted a new 5% lease rate to be phased in over 5 years.

In 2009 results of the periodic appraisal of trust land lots showed many lots having increased significantly in value since the last appraisal in 2003. As a result of the expected large increase in lease fees associated with this increased value, DNRC and the Land Board adopted a compromise policy (entitled Alternative 3B) which uses 5% of an adjusted appraised value based on the average appreciation of state leases, and increases annually by a Lease Fee Indicator, which is limited to a minimum of 3.25% and maximum of 6.5% annually.

The 2011 Montana legislature also addressed the issue of rapidly rising lease fees by passing SB409 which directed the DNRC to institute an open competitive bidding process for currently vacant lots with an initial minimum bid level of 2% of appraised value. The resulting bid levels from these competitive auctions are to be averaged by "neighborhood" and made available as new lease terms to existing lessees.

Characteristics and Trends Associated with Cabinsite Leases and Revenues

In 2010 there were 802 platted cabin lots managed by DNRC in the state, of which 726 were active and leased (Table 1).

As can be seen in Figure 1, while there has been some drop off in the number of active leases in the past few years, the total revenue from the leases has increased steadily. This reflects the fact that increases in lease rates and lot valuations have on average been greater than increases in lost revenues from abandoned leases.

TABLE 1. NUMBERS AND DISTRIBUTION CHARACTERISTICS OF DNRC CABIN LOTS (MARCH 2010).

Characteristic / Statistic	Number of Lots
Total number lots	802
Total number lots ever leased	779
Total number active	726
Total number inactive	53
Total number never before leased	23
East Side	132
West Side	594
On water	377 (52%)
Not on water	349 (48%)

Source: DNRC, TLMD.

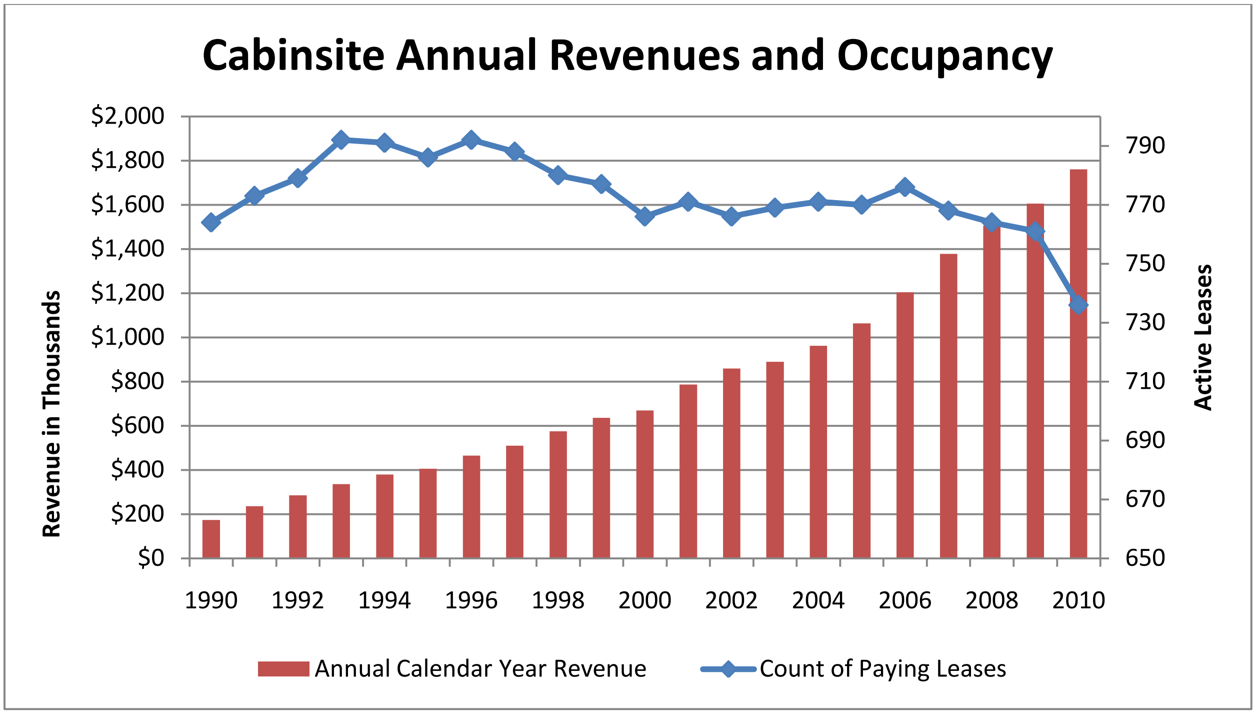

FIGURE 1. TOTAL ACTIVE DNRC LEASES AND TOTAL REVENUE: 1990-2010 (SOURCE, DNRC TLMD)

Figure 2 shows the number of active and leased lots by DNRC land office. This data shows that the largest number of abandonments of lot leases in recent years has occurred in the DNRC Northwest Land Office (Kalispell Region). This is not surprising as this region saw the greatest increase in average lease rents (168% increase) between rents calculated on the 2003 and 2009 appraisals.[1]

[1] DNRC (2009), Table 3, p. 5.

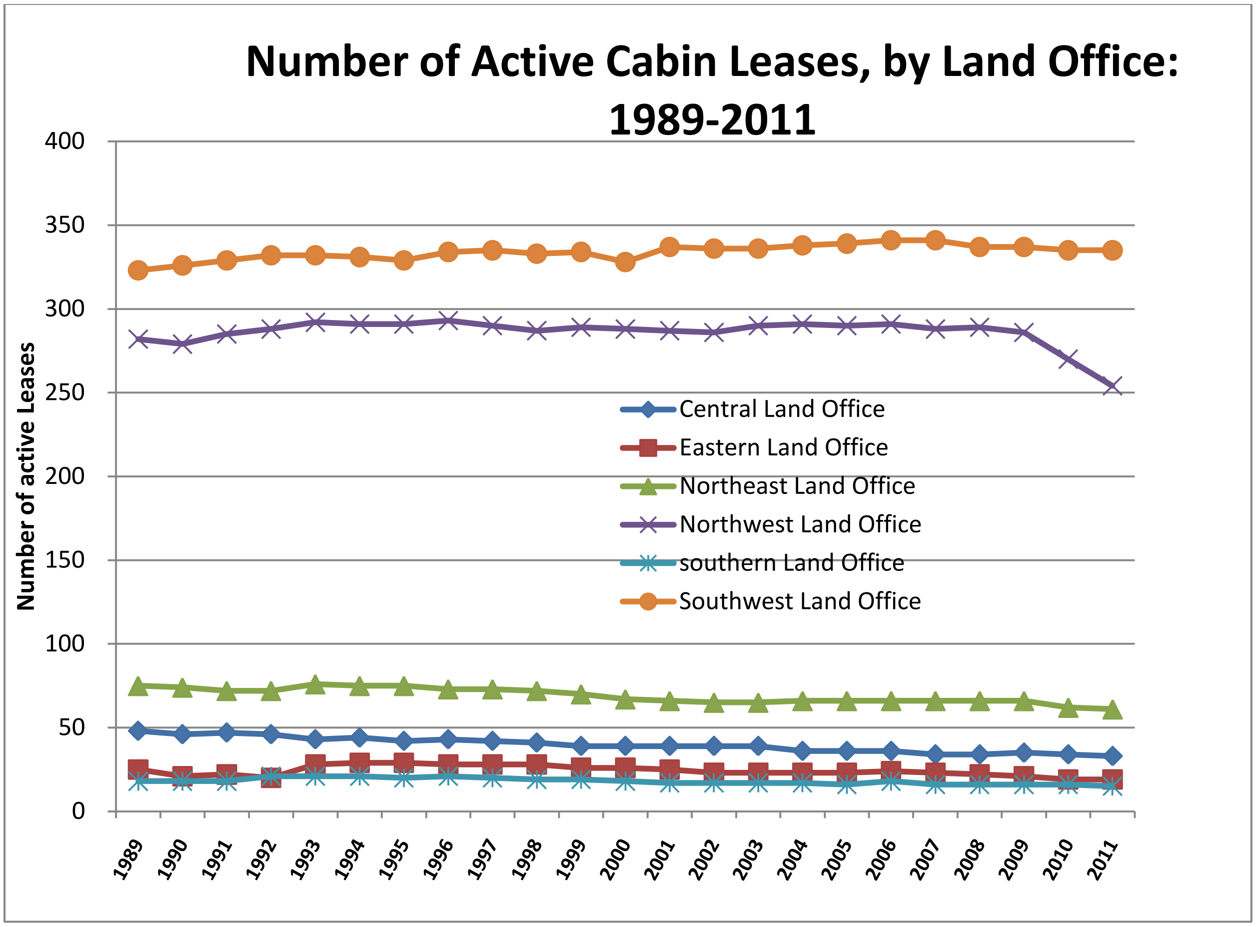

FIGURE 2. PLOT OF ACTIVE CABIN LOT LEASES OVER TIME, BY LAND OFFICE.

Review of Previous Work on Cabinsite Lease Rates

Three primary types of past analyses regarding appropriate lease fees for trust land cabinsites in Montana and Idaho were reviewed for this study. First, are analyses based on data from a single state or area within a state, such as Duffield (1993) and Moe et al. (2009). This data might involve information on leasehold value, appraisal data, or competitive bid data. A second type is a meta-analysis that looks at a variety of parallel lease settings and examples and draws conclusions from prevailing lease rates in these other examples (for example Knipe & Knipe (1998)). In the third type of report the authors provide a less data-based analysis of previous or untested lease valuation methods, and base their conclusions largely on economic or financial principles or laws and statutes (Anderson & Watson 2010a, 2010b)

Table 2 summarizes the recommendations of the previous studies on Montana and Idaho cabinsite lease rates reviewed in this study. Of the reports that provided conclusions/recommendations, the suggested lease rates ranged from 5.0% to 13.0%. It should be noted that while the Moe et al. and Illi reports did not provide specific recommendations or ranges of recommendations, their analyses were anchored largely on the premise that the 5% rate on appraised land value was too high.

It should also be mentioned that there was a certain amount of cross-reference between these studies and their findings. However, rather than being simply restatements of one another, each offers additional data, insights, methods, and analysis to inform the issue.

TABLE 2. SUMMARY OF CABINSITE LEASE RATE REPORTS, METHODS AND CONCLUSIONS: MONTANA AND IDAHO

Study	Type of Analysis	Opinion on Appropriate Rental Rate
Duffield (1993) -- Montana	Leasehold Value Competitive Bid Comparable Appraisal	6.0% to 6.5% 5.0% 8.0% to 12.0%
Knipe & Knipe (1998) -- Idaho	Meta-analysis (multi-method)	6.0 %
Anderson & Watson (2010) -- Idaho	Meta-analysis and Economic Principles, Laws & Statutes	> 6.0%
DNRC (2009) – Montana	Meta-analysis	5.0% to 13.0%
Moe et al. (2009) -- Idaho	Comparable private data model	No final opinion on appropriate rate – limited demonstration model only
Illi (2010) -- Montana	Economic and Real Estate Principles	No opinion given on appropriate rate. Unrestricted competitive bid should set rates.

Updated Data and Analysis

Data and Analysis of Montana Cabinsite Transfers

The transaction/transfer data for Montana cabinsite leases from 2003 to 2011 suggests that over the entire period average full-market lease rates were in the range of 9%. There is however significant difference in average lease rates by year over this period. The most recent complete and partial year data (2010-11) suggest a market lease rate in the range of 5% to 7%. This is generally consistent with both the Duffield (1993) findings and the recommendations of Anderson & Watson (2010a and

2010b) and Knipe & Knipe (1998). Figure 3 shows the average implicit full-market lease rates derived from the Montana cabinsite transfer data by year. Also shown is the number of transfers per year.

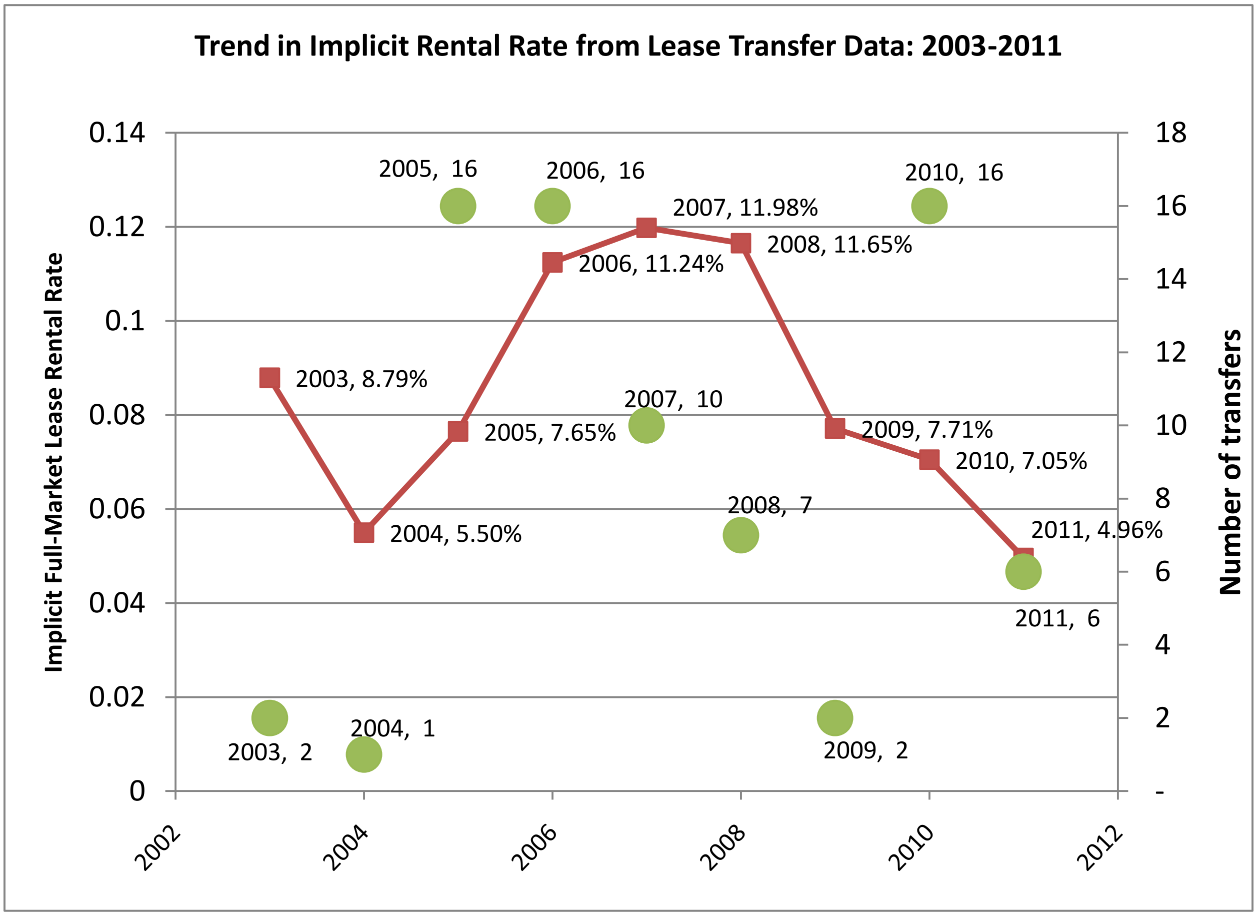

FIGURE 3. PLOT OF IMPLIED APPROPRIATE RENTAL RATE BY YEAR: 2003-2011

Data and Analysis of Competitive Bids for Leases

In his 1993 report, Duffield examined 14 competitively bid DNRC lots for the year 1992. The current data for Montana cabin lots is decidedly thinner. Table 10 shows the details of the appraised values and winning bids for the seven trust land lots that have been competitively bid in the last year. Over the year, for competitively bid leases, the average winning bid has been 4.09% of full 2009 appraised lot value and 5.94% of the Alternative 3B adjusted lot value.

An important point in discussing the data in Table 3 is that DNRC has a number of lots available for lease with details on lot characteristics and minimum bids on their website.[2] Currently there are four active leases undergoing bidding, and 19 inactive leases. Inactive leases become active when someone expresses interest in bidding on the lease. The details of the leasing process are outlined in Appendix B. Many of the inactive leases on the DNRC site have substantial improvements that must also be purchased from the prior lessee by the new lessee. The existence of leasable lots for which no one has expressed interest could indicate several things.

1. For bare lots with no improvements, it might indicate that the minimum bid amount is above the market lease value for that property given substitute properties and lease uncertainty.
2. For Improved lots, it might indicate that the improvements (which must be purchased in a separate transaction) are priced above market value or the combined cost of the lease and the improvements are above market value.
3. A third possibility is that in challenging and uncertain economic times the market for recreational properties, particularly those with split-ownership of land and improvements is very low, thus few bidders are forthcoming.

TABLE 3. WINNING BIDS FOR COMPETITIVELY BID TRUST LAND CABIN LOTS: AUGUST 2010-AUGUST 2011.

Lot ID Number	2009 Appraised Lot Value	3B Adjusted Value	Winning Bid	Minimum Bid	Winning Bid as a % of 2009 Value	Winning Bid as a % of ADJ Value
3063164	$54,006	$27,956	$1,807	$1,398	3.35%	6.46%
3062757	$117,684	$104,194	$8,260	$5,469	7.02%	7.93%
3062129	$45,811	$33,207	$2,013	$1,660	4.39%	6.06%
3062397	$45,300	$34,056	$1,815	$1,703	4.01%	5.33%
3052631	$124,449	$94,153	$4,942	$4,942	3.97%	5.25%
3052860	$80,406	$58,463	$3,075	$3,069	3.82%	5.26%
3053250	$257,160	$147,272	$7,750	$7,364	3.01%	5.26%
Averages	**$103,545**	**$71,329**	**$4,237**	**$3,658**	**4.09%**	**5.94%**

Source: DNRC TLMD

It is difficult to draw significant conclusions from recent DNRC competitive bid data for Trust land cabin lots. While lots have been leased in the past year at 3% To 7% of 2009 appraised lot values, the existence of some of lots with no bidding interest above the minimum bid level raises questions as to whether the averages shown in Table 3 are truly reflective of overall market averages.

[2] http://www.dnrc.mt.gov/cabinsite/default.asp

Many existing lots available for sale have substantial improvements (cabins or houses) which must be purchased in a separate transaction from the lease bidding. The existence of this split-ownership characteristic of the lots introduces many confounding factors into an analysis of available lots and competitive bidding. It should be noted, however, that DNRC has in recent years opened bidding on a small number of lots which received no bids above the minimum,[3] indicating that for that time and those lots, the minimum bid rate was above market-clearing levels.

Data and Analysis of Parallel Examples from other Federal, State, and Private Settings

There have been a number of examinations of market lease rates for recreational lease lots. Perhaps the most exhaustive of these was completed by Knipe & Knipe (1998) for the state of Idaho. In their report, the authors examined examples from Federal (USFS), State, corporate, and private leases. Knipe & Knipe concluded based on the preponderance of the evidence that an Idaho trust land cabin lot should have a market lease rate of about 6% of appraised lot value. This conclusion and rate was in the range of rates suggested by a myriad of other studies as well as actual market examples.

Table 4 shows a number of examples of similar lease rates presented in the literature as well as currently set by federal and state statute for recreational lot leases. It is important to note that each example in the table has its own unique characteristics making direct comparisons across examples difficult.[4] For example, in Minnesota, while the general rate for trust land lot leases is 9% of appraised value, the state legislature passed a law capping the rate at 2% of lakefront lots.

A second example from Minnesota comes from ShoreLand Traditions recreational lots leased by Minnesota Power as cabin sites.[5] The Minnesota Power leases have a lease fee of 2.5% of full-market value of the lot, plus all property taxes. In Minnesota, the median property tax rate is 1.05%, so the average effective rate for these leases is in the range of 3.55%.[6] According to ShoreLand Traditions' web site there are nearly 1,200 Minnesota Power leases.

The examples in the table vary on the high estimate side, ranging up to 13%. However, aside from the Minnesota state land lakefront lot example, minimum rates are generally in the 4% to 6% range.

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[3] Personnel communication, Michael Sullivan, Montana DNRC. August 2011.

[4] Knipe & Knipe present an excellent discussion of various lease provision considerations and how these may affect lease rates in specific examples (Knipe & Knipe pp. 116-121)

[5] A discussion of the details of the Minnesota Power leasing program can be found at http://www.shorelandtraditions.com/lease_info.htm

[6] http://www.tax-rates.org/taxtables/property-tax-by-state

As noted above, rates charged or estimated for parallel settings generally range on the low end of 4% to 6%. While there is a significant spread in the rates charged, this consistency argues against a minimum Montana lease rate below 4% of appraised land value.

A complete comparison of generally comparable recreational lot leases to DNRC Trust Land leases goes beyond simply comparing annual lease rates. The terms and conditions of the leases can also be very different between leases.

The Minnesota Power leases (for instance) begin with a relatively low lease rate (2.5% of appraised value), but lessees are also responsible for taxes on the lot (something Montana lessees are not responsible for). These taxes average 1.05% of the lot value for a total effective rate of 3.55%. Additional restrictions found in the Minnesota Power (MP) leases that are not found in DNRC leases include,

- Long term use of trailers or RVs is not allowed. Only a single cabin may be constructed.
- Upon termination of the lease, all buildings and improvements must be removed within 60 days. If the improvements are not removed within 60 days, MP may remove them at the lessees' expense or take ownership of the improvements itself.

These terms stand in stark contrast to the DNRC lease with generous time provisions for transfer or removal of improvements.

Similar to the case of the Minnesota Power leases, USFS cabin leases (which have a 5% annual lease fee) have a number of restrictive terms and provisions not found in DNRC leases. For example,

- Annual adjustment of fee is based on the Implicit Price Deflator, Gross Domestic Product: limited to a maximum 5% annual increase. If IPD-GDP is > 5%, the additional increase will be implemented in the next year(s) where the IPD-GDP is < 5%. New appraisals are done every 10 years.

- USFS can decide to convert the parcel to a different use, and give lessee a 10 year notice.

- If the leases were to be terminated, the cabin owner must leave and remove their cabin at the end of the final lease period or date of termination. If cabin is not removed, improvements become property of US after "reasonable period" (defined by case officer) but lessee is still liable for costs of removal and site restoration.

- The site is not allowed for use as a permanent residence yet permitted improvements shall be occupied at least 15 days each year, unless otherwise authorized in writing.

- Agreements are non-transferable. If improvements are sold, the new owner must go through the full application process and set up a new lease agreement.

- NON-EXCLUSIVE USE. The use and occupancy authorized by the permits are not exclusive. The Forest Service reserves the right to allow others to use the permit area in any way that is not inconsistent with the holder's rights and privileges under the permit, after consultation with all parties involved.

- OPERATING PLAN. The holder must prepare an operating plan to cover all activities authorized by the permit and at a minimum address requirements for the following:

  1. Maintenance of vegetation, tree planting, and removal of dangerous trees and other unsafe conditions.
  2. Maintenance of the authorized improvements.
  3. Size, placement and description of authorized signs.
  4. Removal of garbage.
  5. Fire protection.
  6. Identification of the person responsible for implementing the operating plan.[7]

Clearly differences in terms and conditions associated with long-term recreational cabinsite leases are important in any comparison of the overall cost and desirability of different lease examples. In the case of the Minnesota Power leases, both use limitations and end of lease requirements are more stringent than those found in DNRC cabinsite leases. Thus, even though these MP leases are marginally cheaper in terms of lease rates (5% v. 3.55%), the lease conditions in the Minnesota cases make those leases less flexible and potentially more costly to use and upon lease termination.

In the case of USFS cabin leases, the Forest Service includes a significant number of restrictive lease terms not found in DNRC leases. Therefore, in addition to these leases being priced the same as DNRC cabinsite leases (5% of appraised value), the range of use and enjoyment rights included in the USFS leases is much more constrained than in the case of the DNRC leases. In terms of overall leases, however, the numbers are similar with 696 USFS recreational residence leases on national forests in Montana compared with 726 active cabinsite leases currently managed by the DNRC.

[7] An example of a standard USFS cabin lease agreement can be found at http://www.fs.usda.gov/Internet/FSE_DOCUMENTS/stelprdb5068623.pdf

TABLE 4. TYPICAL RECREATIONAL LOT LEASE RATES FROM THE LITERATURE, STATUTE, AND MARKET EXAMPLE

Setting / Study	Effective Rate (annual)
USFS	5% (reappraised every 10 years) indexed with Implicit Price Deflator
California	9% of market value
Idaho Trust Lands	4% of past 10 years average value
Minnesota Trust Lands	9% in general but 2% for lakeshore lots
Minnesota Power Leases	2.5% plus all taxes (1.05% average) = 3.55%
Idaho State Parks	5%
Residential leases, Utah and Wyoming	3.25%[8] – 5.5% (Cook & O'Laughlin 2008)
Duffield (1993)	8% - 12%
Knipe & Knipe (1998)	6.5% - 13%
Anderson & Watson (2010)	>6%
Ohio Trust Land	Minimum 10% of appraised value
Utility reservoir lots	4% to 8% (Knipe & Knipe (1998))

Data and Analysis of Impact of Vacancy Rate Trends

One concern highlighted in the DNRC (2009) report related to full implementation of lease rates of 5% of 2009 appraised values was that a large number of leases would be vacated and total revenues to the trust would decline over what had been collected under lower lease rate structures.

DNRC did a good analysis of this possibility and found that a full 18.8% **of the highest valued leases** would have to be vacated in order for total trust revenues from cabinsite leases to fall below the level implied by using 5% of 2003 appraised values as a method of setting lease rates.

Figure 4 shows a comparison of state cabinsite vacancy rates (based on the maximum number of sites rented in 1996) and statewide vacancy rates for homes and rental units.[9] The data for statewide home and rental vacancy rates are limited to the 2004 to 2009 time period. Since the cabinsite leases are often a split-ownership situation (with the lessee owning the improvements and the trust owning the land), they represent an ownership position somewhere between a home and a rental. Consistent with this is the 2004-2009 data showing cabinsite lease vacancy rates generally between home and rental vacancy rates for the state.

[8] Utah uses the Prime Rate to set lease rates. The rate in August 2011 was 3.25%. For comparison in 2008 the rate was 5%.

[9] State and local vacancy rate data are presented by the Department of the Census at http://fastfacts.census.gov/servlet/ADPGeoSearchByListServlet?_lang=en&_ts=331831011737

Since cabinsite vacancy rates have tracked home and rental rates in general proportion in recent years, one conclusion regarding the current spike in vacancy rates for cabinsites might be that it is as much reflective of general local economic conditions as of unsustainable increases in lease fees.

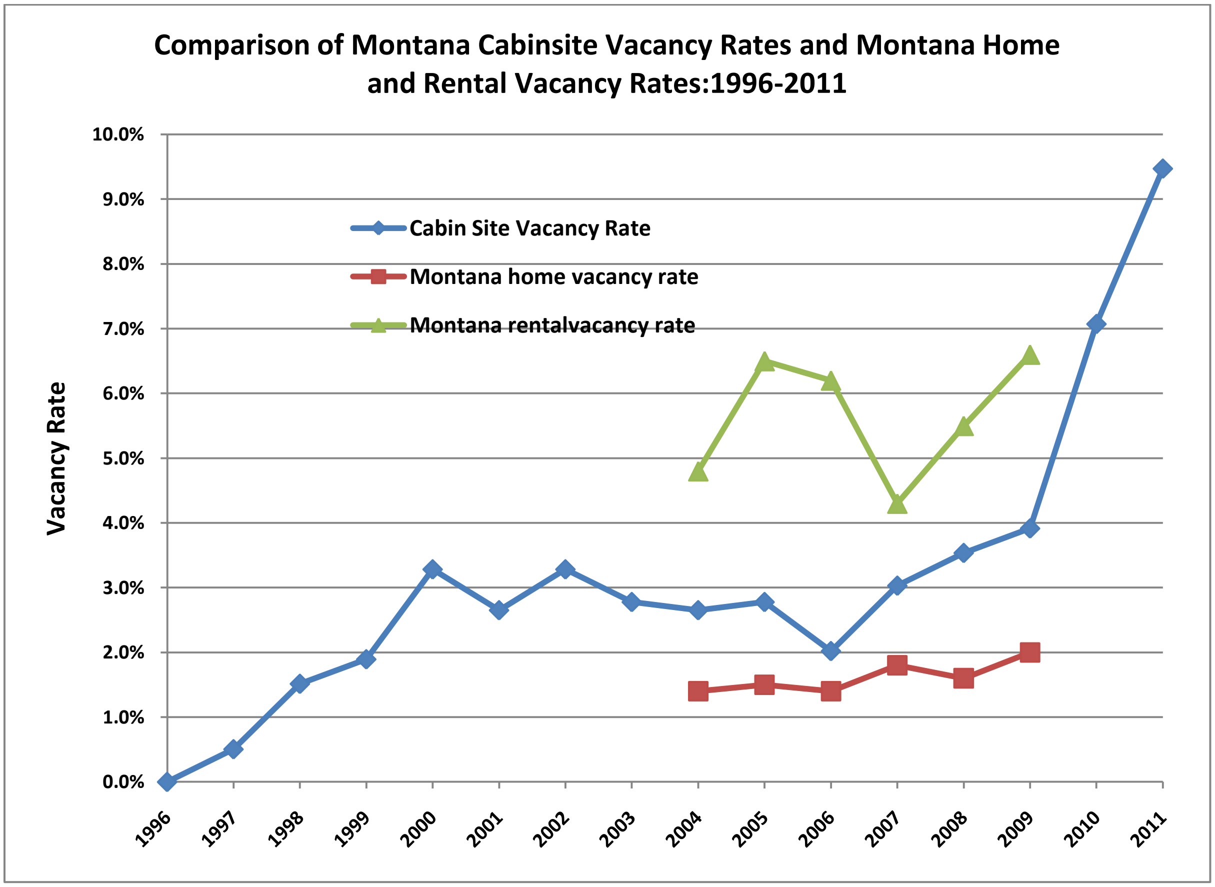

FIGURE 4. COMPARISON OF DNRC CABINSITE VACANCY RATES AND STATE OF MONTANA HOME AND RENTAL VACANCY RATES.

The 2011 vacancy rate is 9.5% for leases. The graph makes it clear that there has been a significant increase in vacancies in the last two years. These vacancies however are likely a function of many factors, including the lease rate/fees, costs of substitute properties/opportunities, the unemployment rate, and average household net worth. At this point the data on cabinsite vacancies does not support development of an explanatory model of vacancy rates as a function of lease rates/fees.

One additional perspective in interpreting cabinsite vacancy rates is provided by foreclosure rates. The greatest number of new lease vacancies for cabinsites has occurred in the last two years in the DNRC Northwest Land Office area. This finding is consistent with foreclosure statistics which show Flathead County, MT as having the highest home foreclosure rate in the state. As of August 2011, nearly 1% of Flathead County homes are in some stage of foreclosure.[10] Therefore, higher vacancy rates in this area may at least in part be merely reflective of broader, or even local, economic conditions, rather than only current lease rates.

Findings, Conclusions and Study Limitations

Study Findings

This analysis has examined data and reports relating to Montana and Idaho cabinsite leasing rates and rate setting. Additionally, we have examined current and recent lease rates for similar trust lands as well as for rental lands in comparable settings. We have examined lease rates implied by Montana lease transfer information, data from competitive bidding for Montana leases, and historical vacancy rates for leases. Finally, we have reviewed both current and recently passed lease rate policy in Montana. The following findings are based on this analysis.

1. Analysis of cabinsite transfer data for the period from 2003 through August 2011 suggests that many lease sales still result in positive leasehold value to the seller. This indicates that the full market rental rate is above the contract rental rate. In the most recent years' data (2010-2011), the implied full market lease rate from the transfer is in the range of 5% to 7%.
2. Analysis of competitively bid leases provides an inconclusive picture of current competitive market rates. While some (7) leases have been bid at above the minimum (5% of adjusted 2009 value) rate, several other lots have been offered for lease and received no bids in the past few years. Additionally, DNRC maintains a list of currently vacant lots available for bid. Taken together this data indicates that current rates are not low enough in the current economic climate to ensure that all lots offered for lease receive bids. However, this does not necessarily imply that the current rates are inconsistent with a policy of revenue maximization for the trust.
3. Past and current examples of recreational lot leases by state trusts, the federal government, and corporations and utilities support the conclusion that market lease rates are generally above 5%.
4. Vacancy data for Montana cabinsites indicate that vacancies have increased significantly in the past three years, particularly in the areas managed by the DNRC Northwest Land Office (Kalispell). The data is not sufficient, however, to draw conclusions as to the likely trend and future vacancy rates and their impact on trust revenues.

[10] www.realtytrac.com/trendcenter/mt/flathead-county-trend.html Accessed August, 2011.

5. SB409 while likely reducing cabinsite vacancies has the potential to lower both current trust revenues and the rate at which those revenues grow in the future.

Conclusion and Opinion on Full Market Revenue Maximizing Lease Rate for Cabinsites.

Based on the preponderance of the evidence both from data on Montana cabinsite rentals, on studies pertaining to parallel State of Idaho sites, and on similar examples from Montana as well as other states, we believe that the current Montana target policy of assessing a minimum 5% annual lease rate on the full appraised value of the cabinsites is appropriate for the goal of maximizing trust returns from this resource.

We recognize that economic conditions have been in recent years, and continue to be, extremely challenging. These conditions have caused a great deal of very real hardship for many Montanans through loss of employment, loss of home and other equity, and lower incomes. The depressed economy has also led, in part, to higher vacancy rates for state leases and lower interest in new leases. We recommend that DNRC closely monitor the trend and composition of any new lease vacancies for additional evidence from which to inform the relationship between lease rates and trust revenue.

Study Limitations

This study is intended to provide an overview and updating of methods developed and conclusions reached regarding appropriate Montana cabinsite lease fees in the Duffield (1993) report. The Duffield methods and updated data were supplemented with reviews of studies, documents, and comparable examples relating to residential recreational lot leases in both Montana and Idaho. Substantial uncertainty exists regarding economic conditions (including unemployment, wage growth, and real estate values) in the near term. The conclusions from this analysis are necessarily backward-looking based on available data. To the extent that Montana economic activity were to decline or stagnate for several more years, conclusions in this report from the analyses of lease transfers, competitive bids, and vacancy rates may marginally overstate the true revenue maximizing lease rate. Conversely, a return to comparatively normal economic times may result in a future situation where a 5% lease rate is below the long term revenue maximizing level.

Qualifications

This report was developed by Dr. John Duffield (Yale PhD. Economics 1974), Dr. David Patterson (University of Iowa, PhD. Statistics, 1983), and Mr. Chris Neher (MA Economics, University of Montana 1989). This research team's area of specialization within natural resource economics is the valuation of the services provided by market and nonmarket resources. Their prior most closely related work includes a suite of fair market value studies undertaken for the then, MT Department of State Lands in the early 1990s, including grazing leases, cropland, cabin rentals and recreation use. That work has since been relied on by the courts in several landmark cases, for example relating to cabin leases in Montana Supreme Court cases that have come to be known as *Montrust I*, and *Montrust II*. This research team also recently completed a study for Montana DNRC to develop methodologies to assess an annual lease fee, whereby State Trust Lands may be utilized for recreational purposes (Bioeconomics, Inc. 2010. Montana School Trust Lands Valuation Methodologies: Application to Whitefish School Trust Lands Neighborhood Plan.) Other closely related work includes serving as the economics expert witness for the Montana Attorney General in PPL Montana, LLC v. State of Montana. In that case the district court relied on Dr. Duffield's theory and findings of facts with respect to the fair market rental for hydropower use of state trust lands. Other related work includes assisting the Montana Natural Resource Damage Program over the last 20 years in valuation of foregone recreation values and groundwater services in the context of the Clark Fork Superfund cases (Montana v. Arco) as well as similar issues recently resolved (2008) concerning the Mike Horse Dam and E. Helena smelter, all of which resulted in significant settlements for the state.

1.0 INTRODUCTION

This report, by Bioeconomics, Inc. of Missoula, Montana, has been prepared under contract number 115380 CSO with the State of Montana Department of Natural Resources and Conservation. The primary task associated with this contract is to:

1. Review the current economic literature to identify other recent studies and data sources that may relate to this issue (In addition to the 1993 Duffield and the 2009 DNRC reports). For example information from the state of Idaho related to cabinsites, such as the Knipe and Knipe report, the PERC report, the lessee association's Warren Illi report, the current cabinsite rules ARM 36.25.1001-1013, and other applicable reports. Additional considerations – at a minimum – shall be given to examination of lease rates/lease agreements of privately held land leased for recreational cabinsites in other states, namely sites owned by power companies around reservoirs.

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4. Analyze any data made available by DNRC on changes in lease rental rates over time and associated site vacancy rates during the same period. This somewhat exploratory analysis will seek to correlate any quantifiable demand relationship between lease rates and site demand from existing data.

Fundamental to any lease valuation is the mandate for DNRC to receive "full market value" in its Trust management activities. According to the Administrative Rules of Montana,

> *"Full market value" means the most probable price in terms of money that a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus; (ARM 36.25.102 (11))*

This report is organized as follows:

Section 1 provides an introduction and history of the Montana cabinsite leasing program

Section 2 Gives an overview of previous literature and studies relating to recreational lot lease valuation in Montana and Idaho

Section 3 analyzes updated data and information relevant to estimating the full-market value of state cabinsite leases

Section 4 Outlines the primary conclusions from and limitations associated with this analysis

1.1 Sources of Data

The current analysis takes as its starting point the report for the Montana Department of State Lands in 1993 on the fair market value for state land cabin leases (Duffield 1993). This report provided a discussion of relevant Montana and Idaho data on lease prices and valuation methods.

The results and conclusions from the 1993 DSL study have been augmented and updated in the current report using a number of sources of data, including:

1.2 Overview of Montana State School Trust Lands

Through the Enabling Act of February 22, 1889, the Congress of the United States gave to the State of Montana two sections of land from every township for common school support. The Enabling and other acts also granted acreage for other educational and state institutions. The original common school grant was for 5,188,000 acres. The additional acreage provided for other endowed institutions included 668,720 acres, for a total of 5,856,720 acres. The total acreage fluctuates through the years due to land sales and acquisitions.[11]

Any proceeds from the sale and permanent disposition of trust lands, or part thereof, must become permanent funds for the support and maintenance of the public schools and the various state institutions for which the lands had been granted. Any rentals received on leased lands, interest earned on the permanent funds arising from these lands, interest earned on deferred payments on lands sold, and all other actual income shall be available for the maintenance and support of the beneficiary schools and institutions.

The purpose of the DNRC Trust Land Management Division (TLMD) is to administer and manage the state trust timber, surface, and mineral resources for the benefit of the common schools and the other endowed institutions in Montana, under the direction of the State Board of Land Commissioners. The board consists of Montana's top elected officials. DNRC organizes its statewide duties through six regional land offices. These location and extent of these offices are shown in Figure 5.

[11] The discussion of Montana School Trust Lands is adapted from http://dnrc.mt.gov/trust/about_us/overview.asp . The DNRC website provides additional information on the location of trust lands statewide and the beneficiaries of the trust.

In managing state trust lands:

> *"The department's obligation is to obtain the greatest benefit for the school trusts. The greatest monetary return must be weighed against the long-term productivity of the land to ensure continued future returns to the trusts."*[12]

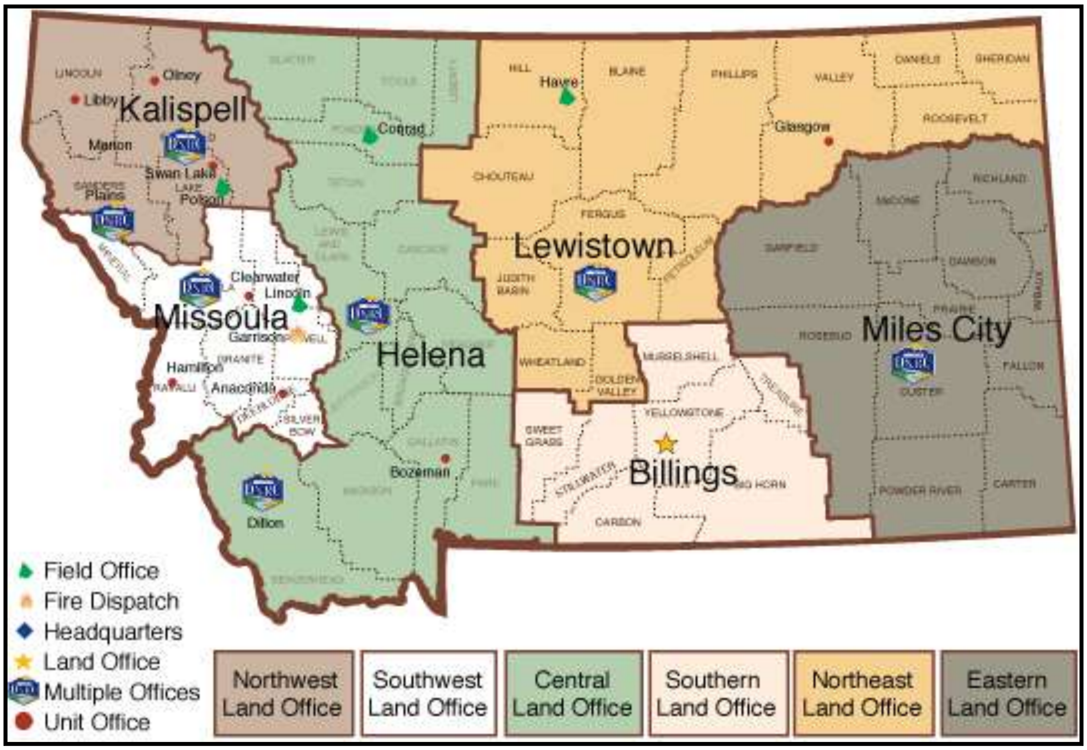

FIGURE 5. STATE OF MONTANA DNRC LAND OFFICES

1.2.1 History of Montana Cabinsite Leasing

One aspect of trust fund management by the TLMD is overseeing the leasing of cabin lots situated throughout the state. In 2010 there were 802 platted cabin lots managed by DNRC in the state, of which 726 were active and leased (Table 5). DNRC provided a timeline of the genesis of the Montana Trust Land cabinsite program in their 2009 analysis of rent calculation alternatives (DNRC 2009). This timeline is included for context and background.

- 1889: Under the Enabling Act of 1889 Congress granted Trust lands to the State of

[12] http://dnrc.mt.gov/trust/about_us/overview.asp last accessed, August 17, 2011.

Montana to be managed for the benefit of public education and other public services. The Enabling Act and the Constitution provide that the lands be administered to return “full market value” to the beneficiaries.[13]

- 1940-50’s: The majority of the cabinsite leases were developed in the late 1940s and early 1950s, and lease rents were reportedly nominal. Initially an annual lease rent of $5.00 was assessed. Later on the lease rent was raised to $50 and $75 annually, with more desirable lots in such places as Placid Lake and Flathead Lake going for $150 annually.

- 1983: Recognizing that the state was not obtaining a market return for cabinsites, the 1983 State Legislature set the lease rent at 5% of the “lease value” of a cabinsite. The DNRC appraised all residential sites and identified the lease value to be 70% of the appraised market value. The 5% lease rate was applied to the 70% of the appraised market value (Appraised value X 70% X 5% = annual lease rent). This method of assessment became effective in 1988.

- 1988: Beginning in 1988, leases were renewed for a 15-year term (using the new method of lease rent assessment described above) with annual lease rent review conducted every five years. Approximately one-fifth of the leases are renewed each year from 1988 to 1992. Leases renewed in 1988 were termed “A” leases; those renewed in 1989 were termed “B” leases, and so on. Thus was established the current staggered renewal cycle.

- 1989: Senate Bill SB226 passed by the 1989 Legislature directed the DNRC to use the appraised market value of the cabinsite lease lots as determined by the DOR through the statewide periodic revaluation of property pursuant to Title 15, MCA. This bill also set the lease rate to 3.5% (which is 70% of 5%) of market value.

- 1993: Senate Bill SB424 passed by the 1993 Legislature directed all rates and rents for surface uses of state trust land be determined by the State Board of Land Commissioners.

- 1994[14]: DNRC hired John Duffield, a Missoula economist, to conduct an analysis of fair market lease rates for all uses of state trust lands. In his analysis of cabinsites on Montana school trust lands, “Task 2: Analysis of Cabin Lease Rates,” he states that “from the standpoint of the [state] school trust, the rental rate should be at a fair market level” [Executive Summary]. Duffield presents three different models for deriving a market lease rate. The first model resulted in a “market rate” of 6.6%, the second model 10.5%, and the third model 12%.

  The Land Board established an advisory council to review current lease rates and make a recommendation to the Board as to what would be an appropriate lease rate. Upon the recommendation of the advisory council the Land Board maintained the lease rate at 3.5% of the appraised market value as determined by the DOR, and

[13] This timeline is excerpted from DNRC (2009), p. 2-4.
[14] The Duffield analysis and report was actually completed in 1993.

increased the minimum rent from $150 to $250 annually.

- 1999: In response to the Land Board's decision to hold lease rates at 3.5% despite the findings of the Duffield Study, the state found itself in court in *Montanans for Responsible Use of the School Trust v. State of Montana*. The plaintiff, also known as "MonTrust," charged that the statutes and rules regulating rent for cabinsite leases failed to ensure full market return to the trusts (in its case MonTrust made reference to the Duffield study mentioned above). On this basis, claimed MonTrust, the statutes and rules were unconstitutional. The Supreme Court ruled in favor of MonTrust, and concluded that the lease rate of 3.5% in rule at the time "violates the trust's requirement that full market value be obtained for the school trust lands and interests therein."

  In its opinion dated November 2, 1999, the Court held that any statute affecting state trust lands must be "consistent with the constitutional mandates of the trust and the state's fiduciary duties as a trustee." The court also confirmed that the state's management of trust lands would be judged by principles applicable to private trusts and described that duty as follows: "When a party undertakes the obligation of a trustee to receive money or property for transfer to another, he takes with it the duty of undivided loyalty to the beneficiary of the trust. The undivided loyalty of a trustee is jealously insisted on by the courts, which require a standard with a "punctilio of an honor the most sensitive." A trustee must act with the utmost good faith towards the beneficiary, and may not act in his own interest, or in the interest of a third person."

- 2000: As a result of the MonTrust case and Supreme Court decision, the Land Board directed the DNRC to establish a negotiated rulemaking committee, charged to negotiate and develop rules that would provide for full market return from cabinsite leases. *Negotiated rulemaking provides a process whereby state agencies may resolve controversial issues by allowing interested parties to participate on a limited basis in agency rulemaking prior to formal rulemaking and adoption.*

  The eleven member committee (comprised of three cabinsite leaseholders, two representatives of the trust beneficiaries, one representative of MonTrust, three representatives of the Land Board, and two members of the DNRC Trust Land Management Division) represented the various interests in the cabinsite lease rate discussion. The committee's proposed recommendations were approved by the Land Board, and the amendments to ARM 36.25.102 and 36.25.110 were adopted January 12, 2001. The amendments increased the cabinsite lease rate to 5% of the DOR appraisal value, to be phased in over five years and addressed how lessees would be compensated for their improvements by a new lessee at the time of assignment

1.2.2 Issues Associated with the 2009 Reappraisal Cycle, and Alternative 3B

The basis of the lease rents charged for the cabinsites is the DOR appraised value of the lots. The DOR uses a six-year appraisal cycle with appraisals having occurred in 2003 and 2009. The period from 2003-2009 saw rapid increases in the appraised value of many cabinsites, reflecting the overall market for real estate in many parts of Montana. From 2003-2009 the average percent ***increase*** in lot value across DNRC land offices ranged from 91% in the Southwest Land Office to 262% in the Eastern Land Office. In total, 141 lots saw appraised values increase by over 200%.

In recognition that many cabinsite lessees had been financially unprepared for the significant increases in annual lease payments based on the 2009 reappraisal values and a 5% lease rate, the Land Board adopted a lease fee calculation using an adjusted appraised value with annual lease fee increases to mitigate steep and unpredictable lease fee increases. DNRC included a description of this new calculation method along with a site specific calculator on their website.[15]

Alternative 3B has been selected by the Land Board as the way residential lease fees will be calculated. Lessees will have the option of signing a supplemental lease agreement (the 2010 SLA) and be charged according to the terms of Alternative 3B. Without a 2010 SLA, lease fees will be calculated per the Current Method (i.e. per the terms of the lease, without phase-in).

Current Method No Phase-in*: Reflects bill amounts if the department continues to use the current method for calculating lease fees (5% of the 2009 DOR appraised value, without a phase-in). The forecasted lease fees under this alternative are based on the assumption that land values will appreciate at a rate of 6.5% annually.*

Alternative 3B*: This method uses the 2003 DOR appraised value, but increases the 2003 DOR value by 6.53% annually to arrive at the adjusted 2009 appraised value. The adjusted 2009 appraised value would then be multiplied by the 5% lease rate to establish a base rent for 2010. There would be no phase-in as not all leases are currently at 5% of the 2003 appraised value though they are expected to all be at 5% of the 2003 DOR appraised value by 2013. After leases attain their 2003 full base fee, lease fees will be based off the 2010 base rent and increase annually by a Lease Fee Indicator, which is limited to no less than 3.25% and no greater than 6.5% annually. Because the LFI varies from year to year, the column below indicates the 3.25% minimum and 6.5% maximum range of the lease fees.*

Because the LFI varies from year to year, the column below indicates the 3.25% minimum and 6.5% maximum range of the lease fees, ***as illustrated below****.*

To see the payment for your particular cabin or homesite lease using either the current method or the Alternative 3B method, enter your lease agreement number below. You will be provided with the

15 http://www.dnrc.mt.gov/trust/remb/billing_outlook.asp? Last accessed on August 15, 2011.

predicted annual lease payment for the next 15 years. If the 2003 DOR appraised value used in the calculator is not accurate, please contact your lease manager in your local DNRC office.

Agreement: XXXXXXXX

2003 DOR Appraised Parcel Value: *$116,279.00*
2009 DOR Appraised Parcel Value: *$266,478.00*
Adjusted 2009 Parcel Value: *$169,954.57*

Year	*Current Method No*	*Alternative 3B Maximum*	*Alternative 3B Minimum*
2011	*$13,323.90*	*$8,920.49*	*$8,920.49*
2012	*$13,323.90*	*$9,500.32*	*$9,210.41*
2013	*$13,323.90*	*$10,117.84*	*$9,509.74*
2014	*$13,323.90*	*$10,775.50*	*$9,818.81*
2015	*$13,323.90*	*$11,475.91*	*$10,137.92*
2016	*$19,441.47*	*$12,221.84*	*$10,467.40*
2017	*$19,441.47*	*$13,016.26*	*$10,807.60*
2018	*$19,441.47*	*$13,862.32*	*$11,158.84*
2019	*$19,441.47*	*$14,763.37*	*$11,521.50*
2020	*$19,441.47*	*$15,722.99*	*$11,895.95*
2021	*$19,441.47*	*$16,744.99*	*$12,282.57*
2022	*$28,367.87*	*$17,833.41*	*$13,519.46*
2023	*$28,367.87*	*$18,992.58*	*$13,958.85*
2024	*$28,367.87*	*$20,227.10*	*$13,519.46*

1.2.3 The 2011 Montana Legislature and SB 409

While the Montana Land Board and DNRC had provided the Alternative 3B lease fee calculation option as an alternative method available to lessees for setting lease rates, the Montana Legislature adopted a different approach. Senate Bill 409, which eventually passed both houses and was allowed to go into law without the signature of the Governor, adopted a modified bidding process as an alternative method of setting lease rates. The new law mandates the use of the most recent DOR appraisal data as a basis for valuation but sets an initial minimum bid rate of 2% of DOR value for a competitive bid process. The full text of SB409 is attached in Appendix A. The specific implications of SB409 for final lease rates is discussed below.

As was done in the 1993 report, the central question examined in this report is whether the current lease rate returns a "full market value" to the school trust as required by the Montana Enabling Act of 1889 and by the Montana Constitution of 1972. As can be seen in Figure 6, while there has been some drop off in the number of active leases in the past few years, the total revenue from the leases has increased steadily. This reflects the fact that increases in lease rates and lot valuations have on average been greater than increases in lost revenues from abandoned leases.

TABLE 5. NUMBERS AND DISTRIBUTION CHARACTERISTICS OF DNRC CABIN LOTS (MARCH 2010).

Characteristic / Statistic	Number of Lots
Total number lots	802
Total number lots ever leased	779
Total number active	726
Total number inactive	53
Total number never before leased	23
East Side	132
West Side	594
On water	377 (52%)
Not on water	349 (48%)

Source: DNRC TLMD.

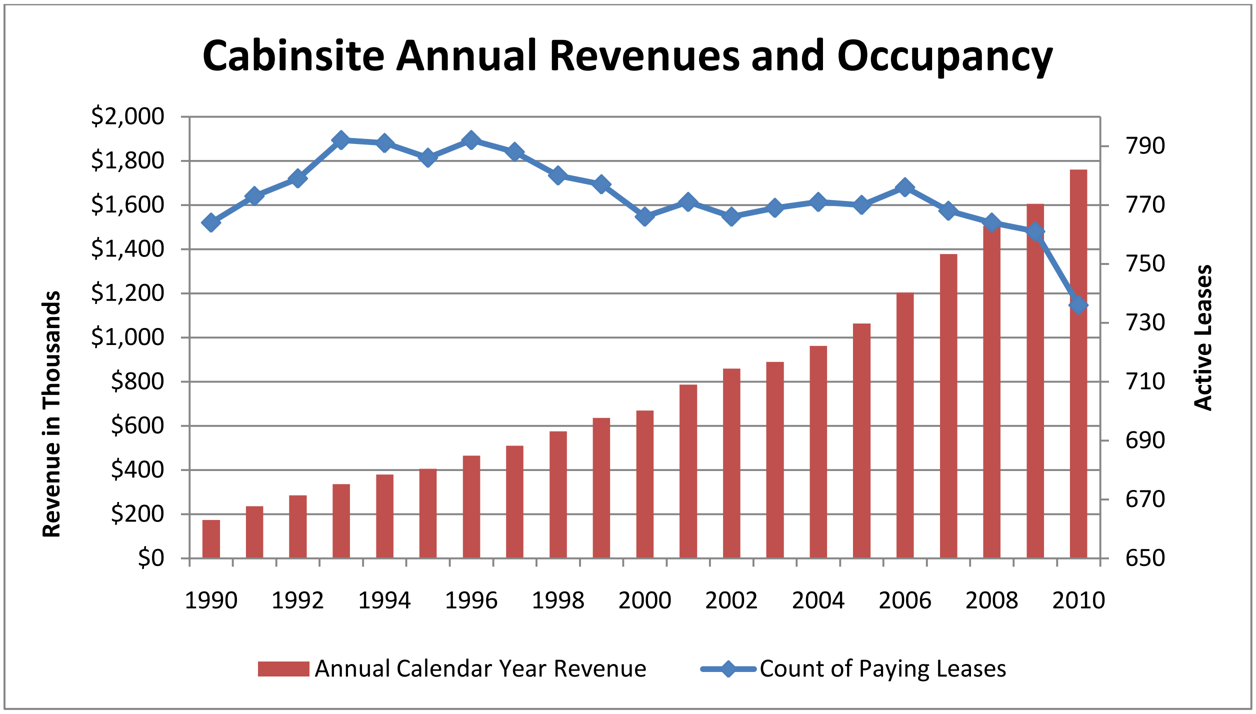

FIGURE 6. TOTAL ACTIVE DNRC LEASES AND TOTAL REVENUE: 1990-2010 (SOURCE: DNRC TLMD)

Figure 6 and Table 6 show the number of active and leased lots by DNRC land office. This data shows that the largest number of abandonments of lot leases in recent years has occurred in the Northwest Land Office (Kalispell Region). This is not surprising as this region saw the greatest increase in average lease rents (168% increase) between rents calculated on the 2003 and 2009 appraisals.[16]

TABLE 6. NUMBER OF DNRC ACTIVE CABIN LOT LEASES BY YEAR AND LAND OFFICE.

Year	Central Land Office	Eastern Land Office	Northeast Land Office	Northwest Land Office	southern Land Office	Southwest Land Office
1989	48	25	75	282	18	323
1990	46	21	74	279	18	326
1991	47	22	72	285	18	329
1992	46	20	72	288	21	332
1993	43	28	76	292	21	332
1994	44	29	75	291	21	331
1995	42	29	75	291	20	329
1996	43	28	73	293	21	334
1997	42	28	73	290	20	335
1998	41	28	72	287	19	333
1999	39	26	70	289	19	334
2000	39	26	67	288	18	328
2001	39	25	66	287	17	337
2002	39	23	65	286	17	336
2003	39	23	65	290	17	336
2004	36	23	66	291	17	338
2005	36	23	66	290	16	339
2006	36	24	66	291	18	341
2007	34	23	66	288	16	341
2008	34	22	66	289	16	337
2009	35	21	66	286	16	337
2010	34	19	62	270	16	335
2011	33	19	61	254	15	335

[16] DNRC (2009), Table 3, p. 5.

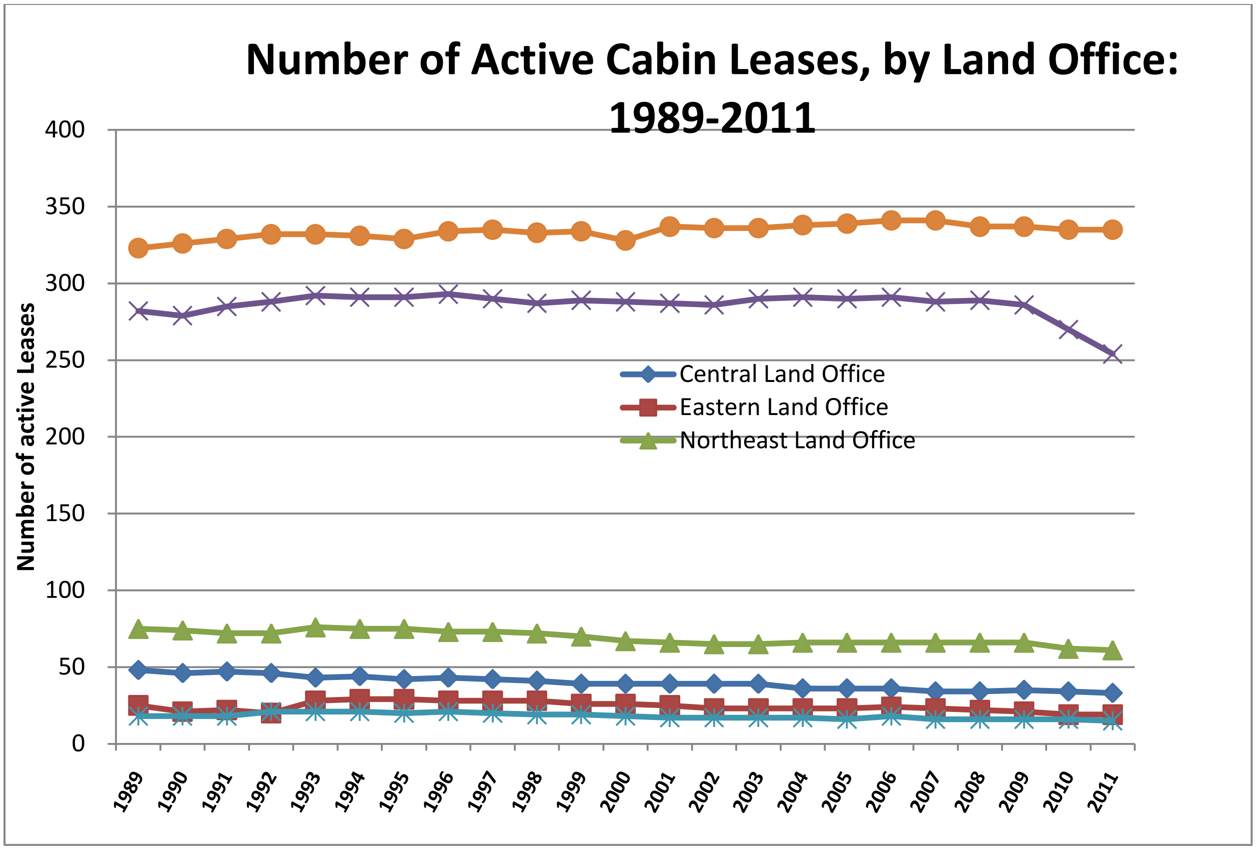

FIGURE 7. PLOT OF ACTIVE CABIN LOT LEASES OVER TIME, BY LAND OFFICE.

2.0 PREVIOUS RESEARCH AND REVIEW OF THE LITERATURE ON CABINSITE LEASE VALUATION

The issue of appropriate state lease rates for cabinsites on trust lands has received significant attention, research, and analysis in recent years, both in Montana and in the neighboring state of Idaho. Duffield (1993) referenced statistics from Idaho cabin lease data in his 1993 report on the fair market value of Montana cabin leases. Additionally, Idaho has commissioned or received several reports on their lease program that both reference the 1993 Duffield report, and expand on its conclusions, and in some cases examine the issue from other perspectives. This section summarizes the current literature on cabinsite lease rates in Montana and other states.

2.1 Overview of Montana DSL 1993 Report Methods and Conclusions

Duffield employed three general approaches to identify a fair market rental rate for recreational properties. Approach 1 was to undertake an appraisal that identifies both fee simple market value and market rents. Approach 2 was to examine the relationship between sales prices in the transfer (or assignment) of leases and appraised values of the lease. And approach 3 was to look at appropriate lease rates implied by competitive bid data for Montana trust cabinsite leases. The conclusions by Duffield are shown in italics for each approach.

2.1.1 Appraisal-based calculation of appropriate rates

The most direct way to identify a fair market rental rate is to collect information on both market rents and property values and simply compute the ratio. These kinds of studies have been undertaken by Thomas Stevens, a Missoula-based appraiser. Mr. Stevens has done appraisals of recreational properties for public agencies both in Idaho and Montana. His findings are that market rental rates are from 8% to 12% of the current market value with most rates in the 10% to 12% range. ***The conclusion of his appraisals has been that 10% is an equitable value.*** (Duffield (1993))

2.1.2 Estimation of Lease Rates Implied by Leasehold Value from Transaction Data

Another approach to estimating market rental rates is to use sales prices in the assignment (or transfer) of state leases from one party to another. The basic idea is that a "leasehold value" is created when the contract rent on a given lease is below the market value. For example, suppose a given site can be leased for $200 per year when the real market value is $400. This difference creates a value (the "leasehold value") associated with holding the lease (an *amount of $400 less $200 every year over the probable term of the lease). In such a situation, an individual may be willing to pay some amount, perhaps several thousand dollars, to the existing leaseholder for the right to take over a lease with a below-market rental rate.*

[Duffield analyzed two Montana] data sets: 1) assignment sales data for a set of five 1992 leasehold assignment sales prices) and two 1990 sales prices for seven Montana DSL cabin sites at McGregor, Seeley, Echo, Rogers and Elbow Lakes; 2) a set of seven 1987 to 1991 assignments derived from an appraisal done at McGregor Lake.

*The Montana data suggests that lease assignment sales in recent years for Montana cabin leases have captured about 45% of the market value for the leaseholder… **In other words, contract rental rates could be increased by about 80% from 3.5% to around 6.5% to allow the state to capture full market value***

2.1.3 Lease Rates Implied by Competitively Bid Leases

*Further insight into the market for Montana state cabin lease sites is provided by examining competitive bids for state leases that come available either through default or new leases. A data set of 14 competitively bid leases is discussed in the main report. High bids received are compared to minimum bids set by DSL. The high bids range from being just barely more than the minimum bid to being almost three times as high as the minimum bid. On average, the high bid is 41% higher than the minimum bid. Taken by itself, **this data suggests that the contract lease rate should increase by 41% (to about 5.0% of appraised value) to equal a market rental rate**. This is somewhat lower than the increase indicated by the lease assignment sales data.*

2.1.4 Duffield (1993) Conclusions

The conclusion of this report is that there is evidence that contract rental rates for Montana cabin lease sites are below the market rental rate. Current contract rental rates are 3.5% of appraised value. When state cabin leases are transferred, the selling party on average for our sample of recent Montana lease assignments receives about 45% of the market value of the unimproved property. Using generally conservative assumptions, market-rental rates derived from leasehold assignment sales prices are on the order of 6.0% to 6.5%. Market rental rates based on competitive bids are on the order of 5.0%. By comparison, market rental rates based on appraisal of market rentals are on the order of 8.0% to 12.0%.

2.2 Post-1993 Research

2.2.1 Knipe and Knipe: State of Idaho

The state of Idaho has faced similar questions as Montana in regards to setting lease fees for cabin sites on state trust lands. Like Montana, Idaho has commissioned studies and grappled with issues related to achieving maximum long term financial return to the trust from the cabinsites within a volatile economic climate and at times adversarial political climate.

The State of Idaho Department of Lands commissioned a comprehensive analysis of the appropriate Idaho cottage site rental rate and conditions (Knipe and Knipe, 2008). This analysis included data from previous studies of trust land cabin site lease rates, evidence from other state rental programs, similar private and corporate lease examples, and federal government leases of recreational cabin sites. Based on the preponderance of the evidence examined by Knipe and Knipe, they concluded:

> *"In acknowledgment of the various factors in this analysis, the concluded minimum economic return we recommend for the State of Idaho, Dept. Of Land's cottage site program,* ***is equal to 6 percent of fee simple market value of the land, each and every year****. This is based primarily on the 10 direct rental comparables researched and discussed in this report, with opinions of market participants, railroad leases, implicit rates from the Duffield model, the work of other appraisers and additional information considered as secondary support.*
>
> *In the absence of the unrestricted escalation clause and with more definitive market data for higher value recreational properties, the reasonable conclusion might well shift upward to 7 or even 8 percent (realize that even some governmental lessors, such as the States of Washington, Alaska and Arizona are reported to be exceeding this rate on their state lands), but in recognition of the fact that any increase is going to be difficult for the [Idaho] Dept. Of Lands and the Land Board to implement after so many years of accepting a nominal return at Payette and Priest Lakes, and the uncertain relationship (if any) between value and rate of return, our conclusion is intentionally conservative.*
>
> *The concluded minimum rate should be applied to lakefront and non-lakefront lots in the same manner."*

2.2.2 Anderson and Watson; State of Idaho

Within the scope debating the Idaho cottage site leasing issue, the Idaho Attorney General's office requested evaluations of the Idaho Cottage Site Lease Program, and later proposed changes in cottage lease terms by Anderson and Watson of PERC (Property and Environment Research Center) in Bozeman, MT.(Anderson and Watson 2010a, 2010b).

At the time of their analysis for the Idaho Attorney General's office, Idaho had a 2.5% rental rate, and a "premium rent" policy that required 10% of any leasehold value associated with the transfer of a site and sale of its improvements be paid to the state.

In their analysis of the then current 2.5% lease rate and 10% premium rent policy, Anderson and Watson (2010a) concluded:

> *"[T]he evidence clearly demonstrates that the Land Board is not meeting its statutory or its constitutional obligations with respect to recreational cottage sites. First, by charging below market rates on undervalued lots the [Idaho] Land Board is failing to secure a market rent from the cottage site leases. Second, the [Idaho] Land Board is managing the cottage sites in a manner that generates significant positive leasehold values, 90 percent of which are captured by transferring lessees."(p.14)*

A second analysis and opinion by Anderson and Watson (2010b) dealt with newly proposed Idaho primary lease terms that included a 4% annual lease rent on the average appraised value of each lot over the most recent 10 years, phased in over a five year period, and an increase of the "premium rent" on transfer leasehold values from 10% to 50% over five years.

The conclusions of Anderson and Watson (2010b) regarding the proposed increased Idaho rates, and changed terms included:

> *"Though the Subcommittee's recommendations regarding the cottage site lease terms are an improvement over the status-quo regarding the rental rate, they nonetheless prevent the [Idaho] Land Board from securing the maximum long-term return for the trust beneficiaries. … Moreover, the contract rental rate is still below prudent market rates of return, including rates charged by other states for similar properties (5 to 5.5 percent).* ***At a minimum the rental rate should equal the implicit rates of return calculated using the Duffield Model (6 percent)."****(p.6)*

2.2.3 DNRC 2009 Analysis of Lease Rate Calculation Alternatives

The release of initial 2009 appraised values for Montana cabinsite lots alerted to DNRC to the fact that recent significant increases in housing values in many areas of Montana would also be reflected in DOR appraisal values for many cabinsites. In anticipation of issues arising from the increased appraisal values,[17] and in order to further understand the issues and evidence associated with setting of appropriate lease rates for Montana cabinsite lessees, DNRC completed a comprehensive analysis of alternative cabinsite lease rent calculations, along with an examination of accumulated evidence regarding the appropriate lease rate for Montana trust land cabinsites (DNRC 2009). The primary findings of the DNRC analysis were (in part):

> *• Lease rents have gone up considerably over the past two appraisal cycles. This has led to unpredictable lease rents for cabin and homesite lessees, particularly in the high amenity, high value areas of the state.*
>
> *• A 15-year lease may not be long enough for some lessees to obtain long-term financing. Administrative Rules of Montana currently allow for a 25-year lease term for lending purposes.*
>
> *• The average change in DOR appraised value from 2003 to 2009 for the state's cabinsite lease sites is 130%. The majority of the cabinsites, 619 sites, which is 81% of all cabinsites, saw an increase of 0% to 200%. A few cabinsites saw appraised values go down between 2003 and 2009. The two sites with the highest rate of increase, at 1142.5% and 1350%, are both in Eastern Montana.*
>
> *• It is quite possible that new vacancies will occur as some lessees reach the upper limit of their ability to afford the lease rents for their cabinsite and homesite lease. There is no model which currently shows a solid relationship between rents and vacancies, nor demonstrates any cause and effect therein.*
>
> *This report concludes that, if rents are set at 5% of the 2009 DOR values, then the top 144 most expensive leases (18.8% of the active leases) must go vacant to reduce total annual revenue below what would be expected if rents remained at 5% of the 2003 DOR value with no additional vacancies. Again, this estimate assumes that only the highest-valued cabinsites (cabinsites with the highest lease rents) are vacated.*
>
> *• An examination of the private market was conducted to analyze lease rates for similar properties.* ***Interviews of appraisers, other state agencies and research of historic Treasury notes were conducted. Lease rates range from 5% to 13% among the various respondents****.*
>
> *• Staff completed a survey of mobile home lots, recreational vehicle sites and cabins from Kalispell and Seeley Lake. Minimal amenities, if any, are provided and these rents could be considered comparable to some of the state lease sites in the area used for primary residences having nominal recreational attributes. Cabin rentals from Kalispell to Seeley*

[17] The 2009 DNRC document reported, "In general, current discussion of revising the policy for calculating rents is driven by concerns raised by lessees that new rents, based on the preliminary 2009 appraised values, are too high for some cabinsite lessees to pay." (DNRC 2099, p. i)

Lake, both on and by water, were also noted. Rents run from $270 to $1,950 per week, varying by whether they are located on water or not, the amenities included and time of year.

• Staff completed a study of non-family transfers … A review was made of all 30 assignments in the Seeley Lake area between August 2003 and May 2009 and all 26 assignments in the greater Kalispell area made between November 2004 and July 2009. Sales prices and closing dates were compiled along with the 2009 DOR appraised values of improvements. …In 44 of the 56 sales lessees realized leasehold value at the time of assignment.

Overall, the DNRC (2009) report was a pragmatic document that recognized the real world impacts of the combined effects of phasing in a 5% lease rate in an environment of rapidly rising lot appraisal values. The document examined available evidence for appropriate lease rates based on parallel settings, the implications of increasing vacancy rates on trust revenues, and proposed alternative lease rate calculation methods to soften the immediate financial impacts of the 2009 DOR appraisals.

2.2.4 Leaseholder Reports

Idaho Moe, Morse, and Corlett (2009) At the request of the Priest Lake and Payette Lake (Idaho) Leaseholder Associations, the Idaho Land Board Cottage Site Subcommittee requested their appraisers to complete a study of market-based leased rates for residential leases. The authors collected 17 examples of private residential rentals of developed lakefront properties.[18] The authors used these 17 examples to construct a statistical relationship between the rental rate (as a percent of the land value) and the land value. Their data included effective lease rental rates (by their calculations) of between 0.77% and 6.44%. Their final predictive model suggested that appropriate lease rates should range from 5% at a lot value of $50,000 down to about 0.8% for a lot value of $800,000. The authors concluded that an appropriate range of lease values based on their limited data would be from 4% for low value lots, down to 1% for the highest value lots.

Moe et al. note the limitations of their study both in terms of limited data, methodology, and the preliminary nature of their investigation. They make special note that the model derived from their data is not their final opinion, and until additional data can be added to the analysis, any conclusions are only presented for demonstration purposes.

Illi (2010) A recent analysis and opinion by Warren Illi, a Kalispell appraiser and consultant addressed the issues of rapidly escalating lease fees amid a recent period of declining land values and difficult economic times in the Flathead region (DNRC Northwest Land Office).

The primary points made by Illi were:

[18] The authors note that only one “high-end” year –around lakefront rental was found in their search, and included in the 17 data points.

- Current and projected lease fee increases for (particularly high-end) Kalispell area lake lots were unaffordable for many current (middle income) leaseholders.
- Due to uncertainty in future lease fees, current leaseholders were not even able to sell their improvements in order to orderly terminate their leases without large financial losses.
- High income people were unlikely to assume the most expensive leases as they would have a preference for buying land outright than leasing.
- The state should offer up dozens of vacant leases for open, unrestricted bidding in order to let the "competitive market" set the appropriate lease rate for these new and existing leases.
- Illi also referenced the Idaho Moe et al. (2009) model to support his contention that higher value lots should have lower percentage lease rates associated with them.

2.2.5 Summary of Previous Research

Three primary type of analysis regarding appropriate lease fees for trust land cabinsites in Montana and Idaho have been discussed above. First, are analyses based on single area data, such as the Duffield and Moe et al. reports. This data might involve information on leasehold value, appraisal data, or competitive bid data. A second, type is a meta-analysis that looks at a variety of parallel lease settings and examples and draws conclusions from prevailing lease rates in these other examples. A third type of analysis provides a less data-based analysis of previous or untested lease valuation methods, and bases conclusions on economic or financial principles and laws and statutes.

Table 7 summarizes the recommendations of the previous studies on Montana and Idaho cabinsite lease rates discussed above. Of the reports that provided conclusions/recommendations, the suggested lease rates ranged from 5.0% to 13.0%. It should be noted that while the Moe et al. and Illi reports did not provide specific recommendations or ranges of recommendation, their analyses were anchored largely on the premise that the 5% rate on apprised land value was too high.

It should also be mentioned that there was a certain amount of cross reference between these studies and their findings. However, rather than being restatements of one another, each offers additional data, insights, methods, and analysis to inform the issue.

TABLE 7. SUMMARY OF CABINSITE LEASE RATE REPORTS, METHODS AND CONCLUSIONS: MONTANA AND IDAHO

Study	Type of Analysis	Opinion on Appropriate Rental Rate
Duffield (1993) -- Montana	Leasehold Value Competitive Bid Comparable Appraisal	6.0% to 6.5% 5.0% 8.0% to 12.0%
Knipe & Knipe (1998) -- Idaho	Meta-analysis	6.0 %
Anderson & Watson (2010) -- Idaho	Meta-analysis and Economic Principles, Laws & Statutes	> 6.0%
DNRC (2009) – Montana	Meta-analysis	5.0% to 13.0%
Moe et al. (2009) -- Idaho	Comparable private data model	No final opinion on appropriate rate – limited demonstration model only
Illi (2010) -- Montana	Economic and Real Estate Principles	No opinion given on appropriate rate. Unrestricted competitive bid should set rates.

3.0 ADDITIONAL DATA AND UPDATED ANALYSIS OF TRUST LAND CABIN SITE LEASE RATES

This section provides additional analysis of recent data not considered within the scopes of the studies of Montana and Idaho cabin lease rates discussed previously. This data and analysis includes, 1) analysis of implied market lease rates from DNRC cabinsite transfer data from 2003-2011, 2) analysis of data from competitive bidding on DNRC cabinsite leases, 3) Summarizing parallel lease cases and rates from other settings/areas, 4) Discussion and analysis of the Moe et al. (2010) and Illi (2010) reports and analyses, 5) Analysis and discussion of Montana cabinsite vacancy rates, and 6) a general discussion and comparison of the potential impacts associated with both the current DNRC alternative 3B and SB 409 on total cabinsite revenue.

3.1 Updated DNRC Lease Transaction Data and Analysis

In the Duffield (1993) report on cabinsite rates in Montana, the author presented the argument that when leases and their improvements are transferred/sold the relationship between the leasehold value[19] associated with the sale and the value of the state-owned cabinsite lot can be used to derive the appropriate annual lot lease rate for the site. This relationship was defined in Duffield's "Model 1" as

Model 1 –

Where:

L =leasehold Value
R_0 =contract rental rate (5% target in Montana)
V =appraised lot value
i =capitalization rate and market rental rate

Model 1, above assumes that the capitalization rate (*i*) is equal to the market rental rate. Duffield also presented another model (model 2) wherein the capitalization rate and market rental rate were not assumed to be equal. This model is defined as

Model 2 –

[19] Leasehold Value is defined as the sales price for the lease and associated improvements to the lot minus the appraised values of the improvements.

Where:

R_m =Market rental rate
i =capitalization rate

For Model 2, the capitalization rate may be a function of the consumer rate of time preference. As a proxy for i we use the current 30-year mortgage rate in the following analysis.

Figure 8 shows a plot of the implied values of i and R_m from model 1 and model 2 respectively for a range of L/V values from the DNRC lot transfer data. As can be seen from the plot of the functions, within a range of L/V ratios from about -.1 to 0.4 the implied market rental rates from the models are nearly identical. The greatest divergence between the two models is seen in L/V values above 0.5 where model 1 implies much higher market rental rates than model 2. In the following analysis of transfer data we use model 1 to estimate market rental rates when L/V < 0 and model 2 when L/V > 0. This choice has the effect of conservatively estimating the implied market rental rate for transactions with high leasehold values relative to the appraised lot value.

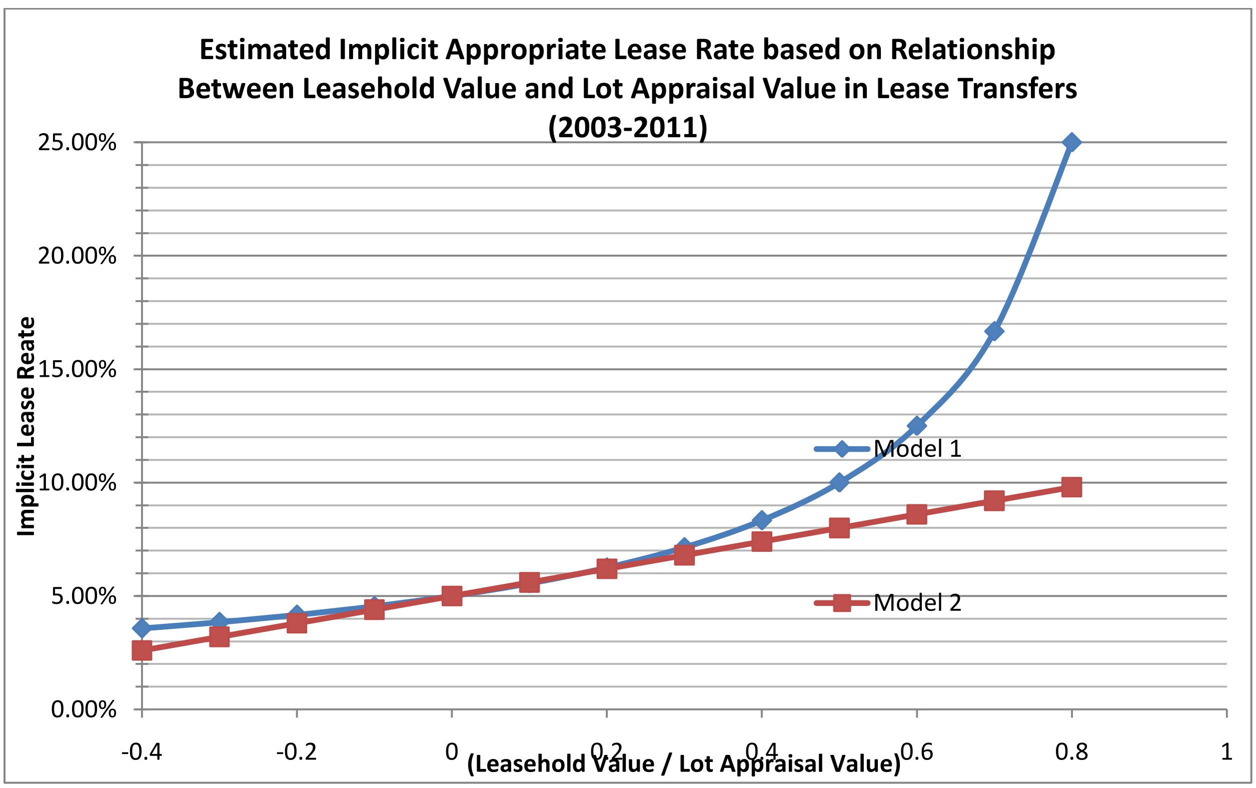

FIGURE 8. PLOT OF IMPLIED LEASE RATES FROM LEASEHOLD VALUE AND LOT VALUE DATA FOR DUFFIELD MODELS 1 AND 2.

It should be noted that two reports on Idaho cottage site lease rates have reviewed the models presented above and in the Duffield (1993) analysis. Both reviews found the methodology sound (Knipe & Knipe (1988) p. 151) and (Anderson & Watson (2010) pp. 5-6), and the Knipe report used the equations and methodology in their own calculations for Idaho cottage site data.

Table 8 shows the key data associated with DNRC cabinsite non-family transfers for the period 2003-2011.[20]

TABLE 8. DNRC REPORTED LEASE SALE/TRANSFER DATA 2003-2011.

Transfer Date	Year	Sales Price	Leasehold Value	Land Value	Leasehold Value / Land Value	Implied Market Lease Rate
8/25/2003	2003	35,000	35,000	35,158	0.995506	9.31%
9/23/2003	2003	28,000	14,370	19,034	0.7549648	8.27%
2/16/2005	2005	40,000	40,000	35,158	1.1377211	9.93%
4/15/2005	2005	108,000	56,840	142,599	0.3986003	6.73%
5/25/2005	2005	85,000	38,190	30,181	1.2653656	10.48%
7/1/2005	2005	79,168	47,648	36,128	1.3188663	10.71%
8/5/2005	2005	56,500	(13,500)	19,406	-0.695661	2.95%
9/16/2005	2005	64,000	56,810	36,955	1.5372751	11.66%
10/28/2005	2005	59,900	22,860	19,778	1.1558297	10.00%
1/23/2006	2006	87,500	16,990	56,892	0.298636	6.29%
5/9/2006	2006	80,000	38,180	17,081	2.2352321	14.68%
5/25/2006	2006	82,900	66,310	16,785	3.9505511	22.11%
6/1/2006	2006	100,000	63,820	35,158	1.8152341	12.86%
8/8/2006	2006	40,000	21,020	39,958	0.5260524	7.28%
8/21/2006	2006	163,000	106,990	35,938	2.9770716	17.89%
9/1/2006	2006	160,000	144,410	61,281	2.3565216	15.20%
9/20/2006	2006	90,000	73,410	16,785	4.3735478	23.94%
12/5/2006	2006	75,000	67,810	36,955	1.8349344	12.95%
1/3/2007	2007	89,500	84,720	33,893	2.4996312	15.82%
1/9/2007	2007	52,000	41,090	19,034	2.1587685	14.35%
7/2/2007	2007	90,000	78,410	39,533	1.9834063	13.59%

[20] Family transfers are excluded from this analysis as these type of transfers are often not considered "arms-length" market transactions that represent the true values which could be obtained in the open market. Additionally, it must be noted that prior to 2010, transfer data regarding sales prices and values of improvements were not required to be reported and thus the data was somewhat inconsistently collected by DNRC. Therefore, the data presented in the table cannot be considered a true census of non-family transfers of trust land cabin sites for the period.

Transfer Date	Year	Sales Price	Leasehold Value	Land Value	Leasehold Value / Land Value	Implied Market Lease Rate
7/30/2007	2007	63,000	12,770	19,933	0.6406462	7.77%
8/20/2007	2007	158,000	138,920	45,008	3.0865624	18.36%
9/14/2007	2007	30,000	16,370	19,034	0.8600399	8.72%
10/19/2007	2007	50,000	36,100	18,941	1.9059184	13.25%
6/16/2008	2008	150,000	60,040	47,710	1.2584364	10.45%
7/21/2008	2008	100,000	48,040	23,748	2.0229072	13.76%
9/30/2008	2008	175,000	144,000	65,028	2.2144307	14.59%
12/15/2008	2008	215,000	178,260	66,529	2.679433	16.60%
5/19/2009	2009	300,000	208,730	172,172	1.2123342	10.25%
11/1/2004	2004	29,510	10,350	89,856	0.1151843	5.50%
3/22/2005	2005	44,000	27,310	121,500	0.2247737	5.97%
3/22/2005	2005	73,000	11,980	91,184	0.1313827	5.57%
4/7/2005	2005	55,000	22,160	124,080	0.1785945	5.77%
5/11/2005	2005	69,000	17,760	110,744	0.1603699	5.69%
5/23/2005	2005	55,000	13,590	111,504	0.121879	5.53%
7/7/2005	2005	20,000	(13,900)	125,234	-0.110992	4.50%
10/20/2005	2005	240,000	122,400	131,618	0.929964	9.03%
11/18/2005	2005	139,000	94,530	116,550	0.8110682	8.51%
11/18/2005	2005	184,400	126,290	124,080	1.0178111	9.41%
3/27/2006	2006	23,000	(16,790)	96,768	-0.173508	4.26%
6/14/2006	2006	150,000	36,760	116,262	0.3161824	6.37%
7/31/2006	2006	139,000	124,820	119,680	1.0429479	9.52%
7/31/2006	2006	50,000	5,650	95,913	0.0589076	5.26%
8/1/2006	2006	95,000	75,590	97,660	0.7740119	8.35%
8/17/2006	2006	75,000	40,180	142,074	0.2828104	6.22%
10/2/2006	2006	95,000	43,760	110,744	0.3951456	6.71%
5/1/2007	2007	45,000	25,840	89,856	0.2875712	6.25%
6/21/2007	2007	299,000	177,820	117,900	1.5082273	11.53%
9/5/2007	2007	250,000	190,550	159,918	1.1915482	10.16%
5/16/2008	2008	95,000	67,740	147,864	0.4581237	6.98%
6/6/2008	2008	245,000	191,730	126,018	1.5214493	11.59%
8/1/2008	2008	59,999	25,679	42,850	0.5992765	7.59%
7/23/2009	2009	69,600	13,114	380,646	0.034452	5.18%

Transfer Date	Year	Sales Price	Leasehold Value	Land Value	Leasehold Value / Land Value	Implied Market Lease Rate
2/23/2010	2010	150,000	48,093	8,180	5.8793399	30.46%
4/23/2010	2010	190,000	53,627	385,648	0.1390569	5.60%
5/14/2010	2010	10,000	-	63,988	0	5.00%
6/28/2010	2010	-	(44,221)	367,290	-0.120398	4.46%
6/30/2010	2010	100,000	65,381	45,811	1.42719	11.18%
7/21/2010	2010	79,297	18,949	93,262	0.2031803	5.88%
7/28/2010	2010	87,650	37,557	49,772	0.7545809	8.27%
8/19/2010	2010	22,500	(10,435)	58,430	-0.17859	4.24%
9/11/2010	2010	37,000	(7,316)	32,075	-0.22809	4.07%
9/28/2010	2010	50,000	(14,418)	349,008	-0.041311	4.80%
9/28/2010	2010	54,000	(27,848)	57,348	-0.485597	3.37%
10/5/2010	2010	37,500	13,884	49,315	0.2815371	6.22%
10/28/2010	2010	35,000	(16,459)	232,836	-0.070689	4.67%
11/4/2010	2010	12,500	(19,030)	380,646	-0.049994	4.76%
11/10/2010	2010	18,000	(1,120)	24,634	-0.045466	4.78%
12/20/2010	2010	40,887	127	49,315	0.002585	5.01%
2/24/2011	2011	48,000	24,384	366,743	0.066488	5.29%
6/1/2011	2011	240,000	102,110	102,510	0.9960979	9.31%
6/14/2011	2011	25,000	(73,254)	37,732	-1.941429	1.70%
6/27/2011	2011	90,000	(1,549)	19,748	-0.078438	4.64%
7/5/2011	2011	50,000	(134,510)	373,978	-0.359674	3.68%
7/8/2011	2011	32,500	9,210	338,565	0.027203	5.14%

Source: DNRC TLMD.

The simple average implied market rental rates from the 2003-2011 transfer data in the table is 9%. As noted this average is based on using the Duffield Model 1 for L/V values less than zero and using Model 2 for values greater than zero.[21]

It is evident that the period from 2003 to the present has been anything but stable in terms of economic conditions in general and real estate values in particular. Table 9 shows the average annual implied market rental rates for the DNRC transfer data for the period 2003-present. A general pattern emerges from the annual averages in Table 9 and shown graphically in Figure 9. Leasehold

[21] Use of Model 2 for all transactions results in a simple average over the term for implied market rental rate of 8.92%

values and associated implied market rental rates generally rose in the period prior to 2009 and have fallen in 2009, 2010, and 2011. This result is consistent with expectations based on declining lakefront lot values and a generally weak economic and real estate climate (particularly for recreational properties).

The most recent partial year of transfer data implies that even in midst of current economic difficult times the market rental rate implied by 2011 transfers is nearly identical to the 5% DNRC target lease rate (4.96%).

TABLE 9. AVERAGE IMPLIED APPROPRIATE LEASE RENTAL RATE BY YEAR: 20003-2011

Year	Average Implied Rate	Number of Transfers
2003	8.79%	2
2004	5.50%	1
2005	7.65%	16
2006	11.24%	16
2007	11.98%	10
2008	11.65%	7
2009	7.71%	2
2010	7.05%	16
2011	4.96%	6

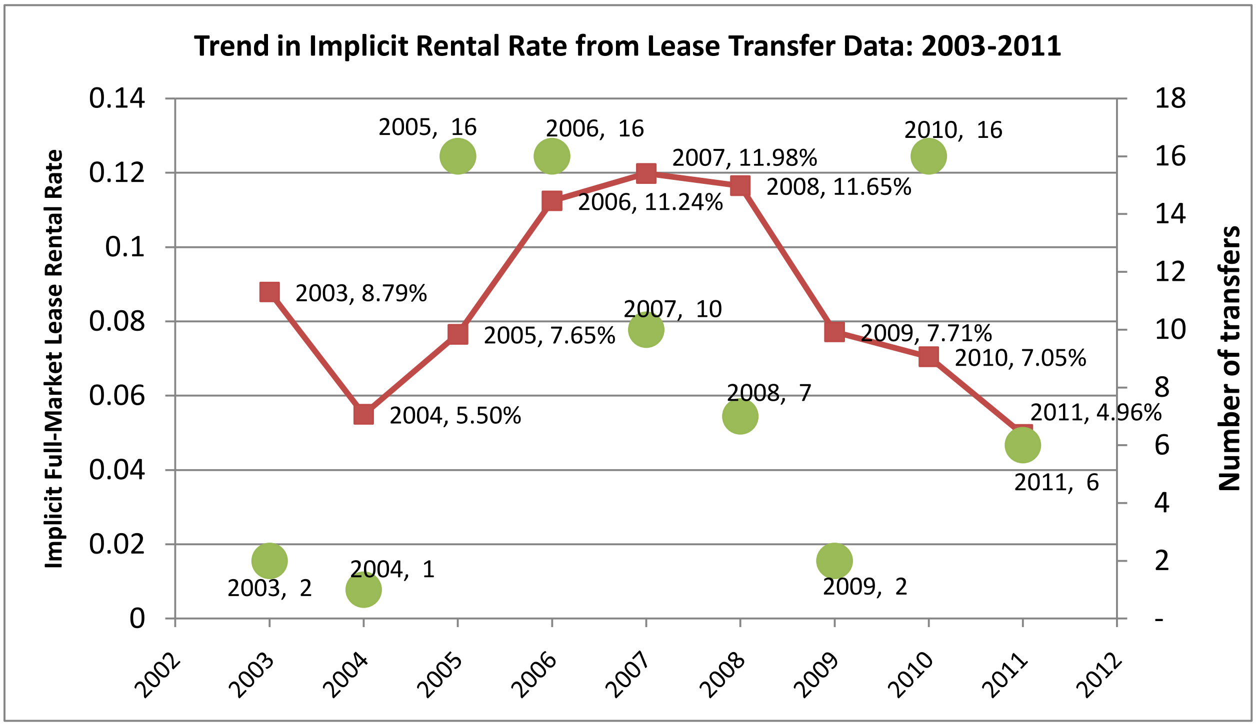

FIGURE 9. PLOT OF IMPLIED APPROPRIATE RENTAL RATE BY YEAR: 2003-2011

3.1.1 Appropriate Lease Rates Implied by Leasehold Value Estimates from Recent Montana Transactions Data

The transaction/transfer data for Montana cabinsite leases from 2003 to 2011 suggests that over the entire period average market lease rates were in the range of 9%. There is however significant difference in average lease rates by year over the period. The most recent complete and partial year data (2010-11) suggest a market lease rate in the range of 5% to 7%. This is generally consistent with both the Duffield (1993) findings and the recommendations of Anderson & Watson (2010a and 2010b) and Knipe & Knipe (1998).

3.2 DNRC Competitive Bids for Leases

In his 1993 report, Duffield examined 14 competitively bid DNRC lots for the year 1992 alone. The current data for Montana cabin lots is decidedly thinner. Table 10 shows the details of the appraised values and winning bids for the seven trust land lots that have been competitively bid in the last year.

Over the year, for competitively bid leases the average bid has been 4.09% of full 2009 appraised lot value and 5.94% of the Alternative 3B adjusted lot value.

An important point in discussing the data in Table 10 is that DNRC has a number of lots available for lease with details on lot characteristics and minimum bids on their website.[22] Currently there are four active leases undergoing bidding, and 19 inactive leases. Inactive leases become active when someone expresses interest in bidding on the lease. The details of the leasing process are outlined in Appendix B. Many of the inactive leases on the DNRC site have substantial improvements that must also be purchased from the prior lessee by the new lessee. The existence of leasable lots for which no one has expressed interest could indicate several things.

1. For bare lots with no improvements, it might indicate that the minimum bid amount is above the market lease value given substitute properties and lease uncertainty.
2. For Improved lots, it might indicate that the improvements (which must be purchased in a separate transaction) are priced above market value or the combined cost of the lease and the improvements are above market value.
3. A third possibility is that in challenging and uncertain economic times the market for recreational properties, particularly those with split-ownership of land and improvements is very low, thus few bidders are forthcoming.

TABLE 10. WINNING BIDS FOR COMPETITIVELY BID TRUST LAND CABIN LOTS: AUGUST 2010-AUGUST 2011.

Lot ID Number	2009 Appraised Lot Value	3B Adjusted Value	Winning Bid	Minimum Bid	Winning Bid as a % of 2009 Value	Winning Bid as a % of ADJ Value
3063164	$54,006	$27,956	$1,807	$1,398	3.35%	6.46%
3062757	$117,684	$104,194	$8,260	$5,469	7.02%	7.93%
3062129	$45,811	$33,207	$2,013	$1,660	4.39%	6.06%
3062397	$45,300	$34,056	$1,815	$1,703	4.01%	5.33%
3052631	$124,449	$94,153	$4,942	$4,942	3.97%	5.25%
3052860	$80,406	$58,463	$3,075	$3,069	3.82%	5.26%
3053250	$257,160	$147,272	$7,750	$7,364	3.01%	5.26%
Averages	**$103,545**	**$71,329**	**$4,237**	**$3,658**	**4.09%**	**5.94%**

[22] http://www.dnrc.mt.gov/cabinsite/default.asp

3.2.1 Appropriate Lease Rates Implied from Recent Competitive Bid Data

It is difficult to draw significant conclusions from recent DNRC competitive bid data for Trust land cabin lots. While lots are currently being leased at 3% To 7% of 2009 appraised lot values, the existence of a number of lots with no bidding interest above the minimum bid level raises questions as to whether the averages shown in Table 10 are truly reflective of overall market averages.

Many existing lots available for sale have substantial improvements (cabins or houses) which must be purchased in a separate transaction from the lease bidding. The existence of this split-ownership characteristic of the lots introduces many confounding factors into an analysis of available lots and competitive bidding. It should be noted, however, that DNRC has in recent years opened bidding on a small number of lots which received no bids above the minimum,[23] indicating that for that time and those lots, the minimum bid rate was above market levels.

3.3 Parallel Examples from other Federal, State, and Private Settings

There have been a number of examinations of market lease rates for recreational lease lots. Perhaps the most exhaustive of these was completed by Knipe & Knipe (1998) for the state of Idaho. In their report, the authors examined examples from Federal (USFS), State, corporate, and private leases. Knipe & Knipe concluded based on the preponderance of the evidence that an Idaho trust land cabin lot should have a market lease rate of about 6% of appraised lot value. This conclusion and rate was in the range of rates suggested by a myriad of other studies as well as actual market examples.

Table 4 shows a number of examples of similar lease rates presented in the literature as well as currently set by federal and state statute for recreational lot leases. It is important to note that each example in the table has its own unique characteristics making direct comparisons across examples difficult.[24] For example, in Minnesota, while the general rate for trust land lot leases is 9% of appraised value, the state legislature passed a law capping the rate at 2% of lakefront lots.

A second example from Minnesota comes from ShoreLand Traditions recreational lots leased by Minnesota Power as cabin sites.[25] The Minnesota Power leases have a lease fee of 2.5% of full-market value of the lot, plus all property taxes. In Minnesota, the median property tax rate is 1.05%,

[23] Personnel communication, Michael Sullivan, Montana DNRC. August 2011.
[24] Knipe & Knipe present an excellent discussion of various lease provision considerations and how these may affect lease rates in specific examples (Knipe & Knipe pp. 116-121)
[25] A discussion of the details of the Minnesota Power leasing program can be found at http://www.shorelandtraditions.com/lease_info.htm

so the average effective rate for these leases is in the range of 3.55%.[26] According to ShoreLand Traditions' web site there are nearly 1,200 Minnesota Power leases.

The examples in the table vary on the high estimate side, ranging up to 13%. However, aside from the Minnesota state land lakefront lot example, minimum rates are generally in the 4% to 6% range.

As noted above, rates charged or estimated for parallel settings generally range on the low end of 4% to 6%. While there is a significant spread in the rates charged, this consistency argues against a minimum Montana lease rate below 4% of appraised land value.

A complete comparison of generally comparable recreational lot leases to DNRC Trust Land leases goes beyond simply comparing annual lease rates. The terms and conditions of the leases can also be very different between leases.

The Minnesota Power leases (for instance) begin with a relatively low lease rate (2.5% of appraised value), but lessees are also responsible for taxes on the lot (something Montana lessees are not responsible for). These taxes average 1.05% of the lot value for a total effective rate of 3.55%. Additional restrictions found in the Minnesota Power (MP) leases that are not found in DNRC leases include,

- Long term use of trailers or RVs is not allowed. Only a single cabin may be constructed.
- Upon termination of the lease, all buildings and improvements must be removed within 60 days. If the improvements are not removed within 60 days, MP may remove them at the lessees' expense or take ownership of the improvements itself.

These terms stand in stark contrast to the DNRC lease with generous time provisions for transfer or removal of improvements.

Similar to the case of the Minnesota Power leases, USFS cabin leases have a number of restrictive terms and provisions not found in DNRC leases. For example,

- Annual adjustment of fee is based on the Implicit Price Deflator, Gross Domestic Product: limited to a maximum 5% annual increase. If IPD-GDP is > 5%, the additional increase will be implemented in the next year(s) where the IPD-GDP is < 5%. New appraisals are done every 10 years.

- USFS can decide to convert the parcel to a different use, and give lessee a 10 year notice.

- If the leases were to be terminated, the cabin owner must leave and remove their cabin at the end of the final lease period or date of termination. If cabin is not removed, improvements become property of US after "reasonable period" (defined by case officer) but lessee is still liable for costs of removal and site restoration.

[26] http://www.tax-rates.org/taxtables/property-tax-by-state

- The site is not allowed for use as a permanent residence yet permitted improvements shall be occupied at least 15 days each year, unless otherwise authorized in writing.

- Agreements are non-transferable. If improvements are sold, the new owner must go through the full application process and set up a new lease agreement.

- NON-EXCLUSIVE USE. The use and occupancy authorized by the permits are not exclusive. The Forest Service reserves the right to allow others to use the permit area in any way that is not inconsistent with the holder's rights and privileges under the permit, after consultation with all parties involved.

- OPERATING PLAN. The holder must prepare an operating plan to cover all activities authorized by the permit and at a minimum address requirements for the following:

  1. Maintenance of vegetation, tree planting, and removal of dangerous trees and other unsafe conditions.
  2. Maintenance of the authorized improvements.
  3. Size, placement and description of authorized signs.
  4. Removal of garbage.
  5. Fire protection.
  6. Identification of the person responsible for implementing the operating plan.[27]

Clearly differences in terms and conditions associated with long-term recreational cabin site leases are important in any comparison of the overall cost and desirability of different lease examples. In the case of the Minnesota Power leases, both use limitations and end of lease requirements are more stringent than those found in DNRC cabinsite leases. Thus, even though these Minnesota Power leases are marginally cheaper in terms of lease rates (5% v. 3.55%), the lease conditions in the Minnesota cases make those leases less flexible and potentially more costly upon lease termination.

In the case of USFS cabin leases, the Forest Service includes a significant number of restrictive lease terms not found in DNRC leases. Therefore, in addition to these leases being priced the same as DNRC cabinsite leases (5% of appraised value), the range of use and enjoyment rights included in the USFS leases is much more constrained than in the case of the DNRC leases. In terms of overall leases, however, the numbers are similar with 696 USFS recreational residence leases on national forests in Montana compared with 726 active cabinsite leases currently managed by the DNRC.

[27] An example of a standard USFS cabin lease agreement can be found at http://www.fs.usda.gov/Internet/FSE_DOCUMENTS/stelprdb5068623.pdf

TABLE 11. TYPICAL RECREATIONAL LOT LEASE RATES FROM THE LITERATURE, STATUTE, AND MARKET EXAMPLE

Setting / Study	Effective Rate (annual)
USFS	5% (reappraised every 10 years) indexed with Implicit Price Deflator
California	9% of market value
Idaho Trust Lands	4% of past 10 years average value
Minnesota Trust Lands	9% in general but 2% for lakeshore lots
Minnesota Power Leases	2.5% plus all taxes (1.05% average) = 3.55%
Idaho State Parks	5%
Residential leases, Utah and Wyoming	3.25%[28] – 5.5% (Cook & O'Laughlin 2008)
Duffield (1993)	8% - 12%
Knipe & Knipe (1998)	6.5% - 13%
Anderson & Watson (2010)	>6%
Ohio Trust Land	Minimum 10% of appraised value
Utility reservoir lots	4% to 8% (Knipe & Knipe (1998))

3.3.1 Appropriate Lease Rates Implied from Parallel Setting Examples

As noted, rates charged or estimated for parallel settings generally range on the low end to 4% to 6%. While there is a fair range in the rates charged, this consistency argues against a Montana lease rate below 4% of appraised land value

3.4 Idaho Priest and Payette Lake Leaseholder Associations Appraisers' Analysis

One analysis of Idaho recreational leases was completed by Moe et al. (2009). This analysis attempted to estimate a statistical relationship between annual lease rates for a set of 17 Idaho private lakefront properties and the land value of those properties. The goal of this exercise was to develop a statistical function that could then be used to calculate the appropriate lease rates for Idaho Cottage leases.

As discussed in Knipe & Knipe (1998), there are many characteristics of residential leases that are largely determinative of the market rental rates for the properties. One significant weakness of the

[28] Utah uses the Prime Rate to set lease rates. The rate in August 2011 was 3.25%. For comparison in 2008 the rate was 5%.

Moe model and data is that it assumes comparability between trust land lot leases and their set of 17 private residence leases. As Anderson & Watson (2010a) note,

> *"The most obvious variables omitted from the Moe, Corlett, and Morse market rent methodology are the differences between private rental agreements compared to state-owned cottage site leases."(p. 8)*

These differences include different lengths of leases, different rights to sell, and transfer leases, and different rights to construct improvements. As Anderson & Watson note, the comparison between the private examples in the Moe study and trust leases is a "wholly irrelevant comparison of rental rates (p.7)." Without controlling for differences in lease terms and lot characteristics in their analysis (which would have likely made a regression analysis impossible given the limited sample size), the Moe et al. model does little to inform any discussion of appropriate trust land rental rates.

In all fairness, Moe and his co-authors state that the model presented is not their final opinion on appropriate rates, and is presented only as a demonstration of an analysis concept applied to a limited sample of data. Although Moe et al. took pains to qualify their results and stress their limitations, others have largely ignored those caveats in citing the Moe et al. study.

Aside from the basic methodological flaw in the Moe method of extrapolating appropriate trust land lease rates from observed private lease rates without controlling for the many differences that may exist between those two general classes of leases, Moe et al. also made errors in the model they did estimate.

Figure 10 shows the estimated relationship as reported by Moe et al. in their 2009 report to the Cottage Site Subcommittee of the Idaho Land Board. The Appraisers' conclusions were that rates should range from 4% for low-valued lots down to 1% for the highest valued lots. They note that the fitted rate flattens out around 1% for the highest valued lots. This is however simply a result of the logistic functional form they have chosen to fit the data to. Had they chosen a (less theoretically appealing) quadratic form, their model would have improved substantially in its ability to explain variation in the data (from an r-square of .75 in the model they report to one of .85 for the same model with a quadratic functional form). The resulting curve would have formed a U with a minimum at around $500,000 lots, and increasing substantially for lots valued above that.

This result is not mentioned to suggest that it is preferable to the one reported by the Idaho group. Rather, it is meant to highlight that the result reported in the Idaho study was not the "best" model possible using the limited data, but rather the best one that did not call into question the data.

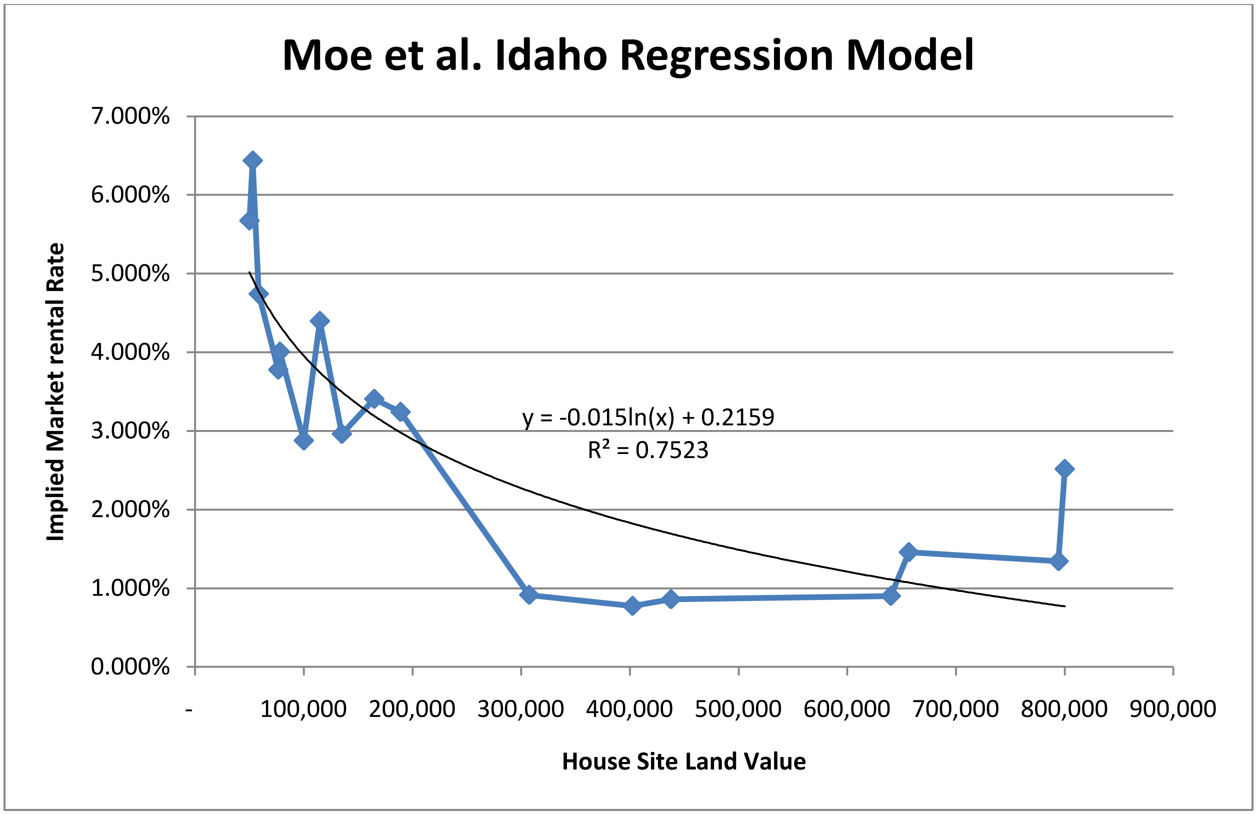

FIGURE 10. PRIVATE LEASE RATE-LOT VALUE RELATIONSHIP AS REPORTED BY MOE ET AL. (2009)

In addition to their somewhat arbitrary choice of a functional form for their model, the Idaho group was inconsistent in their application of extracting the marginal rent attributable to improvements in their data from those attributable to land. In their text example of the method (Moe et al. (2009 p.2) they correctly apply the assumed 1.7% annual depreciation to the value of improvements only in their calculation of a base rental rate for land. However, in their actual spreadsheet calculations they apply the 1.7% to the entire estimated rental rate (land and improvements). The difference is not trivial. Figure 11 shows the estimated relationship corrected for the misapplication of the 1.7% depreciation rate. At the highest lot value ($800,000) the predicted rate rises from about 0.8% to 2.2%.

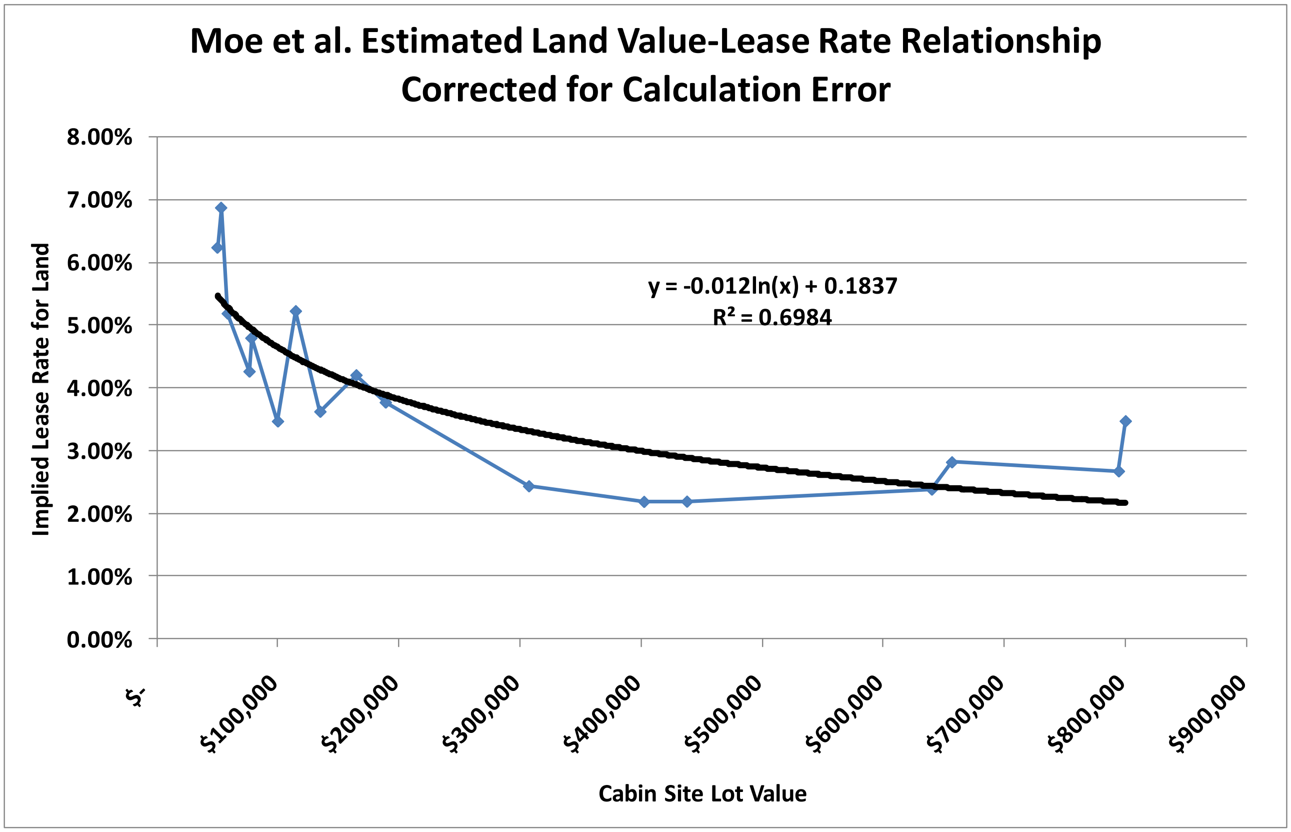

FIGURE 11. MOE ET AL. (2009) MODEL CORRECTED FOR ERROR IN ADJUSTING FOR IMPROVEMENT DEPRECIATION.

Again, we stress that the corrected relationship in Figure 11 is not presented as an example of appropriate lease rates for trust land leases. In our opinion, the fundamental flaws of the model presented make it inappropriate for extrapolation to any Trust land lease in either Idaho or Montana.

3.5 Discussion of Illi (2010) Analysis and Report on Appropriate Methods for Setting Montana Cabinsite Lease Rates

In 2010, Warren Illi, an appraiser from Kalispell, wrote a report analyzing the problem posed by rapidly rising lease fees, and proposing a solution for establishing annual lease fees (Illi 2010). His primary points were:

1. There is little to no long term leasing of private land for residential or recreational purposes in Montana and the U.S. so there is no market data available for setting lease fees.

2. The state of Montana through its implementation of alternative 3B will force many leaseholders into default in that they will not be able to afford their new higher lease fees, but also will not be able to sell their improvements for what they feel they are worth in the existing lease/real estate market.
3. Montana has failed in some recent years to attract bids on certain bare land leases, indicating that the 5% of appraised value minimum bid is set too high to accurately reflect the market price.
4. The answer to establishing a fair market price for the lots is to offer up the "dozens" of vacant lots DNRC currently has for unrestricted bid. With no minimum bid specified, Illi believes the market will determine a full market rental rate for these properties. This rate information could then be expanded to develop market value rental rates for other state leases.
5. Illi cites the Moe et al. (2009) Idaho study discussed above as evidence that rental rates should be significantly below 5% of appraised value.

The points raised by Illi are not without some appeal. However the authors feel Illi basically misunderstands the structure of the market for state-owned recreational lot leases and the constitutional mandate the Land Board and DNRC is operating under. Illi's major points are discussed in turn below.

(1) There is little to no long term leasing of private land for residential or recreational purposes in Montana and the U.S. so there is no market data available for setting lease fees.(Illi p.6)

Illi is correct in noting the unique nature of state-owned recreational lot leases and that there is little in the way of local *private* long-term lease examples upon which to base rates. However, the private market is not the only source of market evidence. As discussed extensively previously in this report as well in the Knipe & Knipe (1998) and Anderson & Watson (2010a 2010b), there are many examples from federal and state government, industry and utilities, and some private transactions that demonstrate the willingness of buyers and sellers to enter into long-term lease agreements for recreational lots at the 5% annual rate and above. To say there is no market data available is to ignore tens of thousands of USFS leases at a 5% rate as well as state leases in places such as Wyoming, Ohio and California at a 5.5%, 10% and 9% rate, respectively.

(2) The state of Montana through its implementation of alternative 3B will force many leaseholders into default in that they will not be able to afford their new higher lease fees, but also will not be able to sell their improvements for what they feel they are worth in the existing lease/real estate market.(Illi p.ii)

The issue of leaseholders defaulting on leases they can no longer afford, either due to increased lease fees, family economic challenges, or a combination of these factors, is a difficult one. The issue is made even more difficult in cases where lessees are forced to sell improvements on their leases into a depressed and uncertain market, if indeed a sale can even be made. The authors fully recognize these difficulties. It is with this understanding well in mind the following observations are made.

The state constitution as well as Montana Supreme Court rulings are clear on the obligation of the Land Board for managing Trust lands. Article X, Section 11, of Montana's Constitution provides that School Trust Lands "shall be held in trust for the people, to be disposed of as hereafter provided, for the respective purposes for which they have been or may be granted, donated, or devised." The Montana Supreme Court has clearly stated the terms of this trust:

> *The grant of lands for school purposes by the federal government to this state constitutes a trust [citations omitted]; and the State Board of Land Commissioners, as the instrumentality created to administer that trust, is bound, upon principles that are elementary, to so administer it as to secure the largest measure of legitimate advantage to the beneficiary of it. Rider v. Cooney, 94 Mont. 295 at 307, 23 P.2d 261 (1933).*

"The largest measure of legitimate advantage to the beneficiary" is taken in this analysis to mean the greatest long-term revenue from management of the trust lands.

One of the fundamental issues faced by any decision-making body, be it governmental, industry, or private in setting rates for multiple lots is whether to set one rate for all lots, or unique rates for each lot. Using one constant rate applied to the market value of each lot essentially controls for differences in quality (and thus value) across the sites, as the appraised value varies among lots reflecting differences in setting, size, amenities, and location. The state of Montana, like many other states, has chosen to adopt one annual lease percentage rate across all lots.[29] A natural result of this choice is that the rate which returns the greatest revenue to trust beneficiaries may indeed result in a significant number of vacant leases.

Under the use of a single lease rate, the "full market price" could be interpreted to be the annual lease rate which returns the greatest revenue to the beneficiaries—regardless of how many lots are leased. This is a fundamental difference in definition between a "market clearing" price and a "revenue maximizing price."

A look at historic vacancy rates for cabinsites in Montana shows some lots vacant even under pre-2000 rates of 3.5% of 1998 values. Rather than lowering the statewide lease rate until the point that all sites become leased, the revenue maximizing action for the state is to raise the rate until revenue is maximized.[30]

Overall, the situation is a difficult one. The Land Board as trustee has a constitutional obligation to maximize the long-term return on the asset for the beneficiaries. Yet some long-term leaseholders may be priced out of the market for state lots, or worse, be forced to sell lot improvements at a significant loss. It is because of this fundamental conflict that the issue of setting a full market lease rate on cabinsite rentals has proved so difficult to settle.

[29] This situation is complicated in that different lots are in different stages of having the chosen lease rate (5%) fully phased-in, and will be so for a number of years to come.

[30] This discussion assumes that administration of additional leases has very low marginal costs that can be largely borne by existing DNRC staff.

(3) Montana has failed in some recent years to attract bids on certain bare land leases, indicating that the 5% of appraised value minimum bid is set too high to accurately reflect the market price.(Illi p.ii)

Illi is correct in noting that in recent years DNRC has put a few sites up for bid and received no qualifying bids.[31] Additionally, there are a number of currently inactive sites that could be put up for bid should someone express interest in them. On the other side of the equation, there have been seven leases completed above the minimum 5% of adjusted value rate in the past year. Taken together these pieces of information suggest that a 5% rate (at the current time, and in the current economy) is not a "market clearing" price (where all cabinsites find willing bidders). It may be, however, a revenue maximizing price for the trust. As 2010 cabinsite revenue shows, even with increased vacancies, revenues still are increasing as new rates are phased in.

The point by Illi about lots not being bid on is only partly relevant to the issue of setting lease rates. It is assumed that a revenue maximizing rate will be associated with some level of vacancy and some lots will go unbid. However, the relevant issue is not how many lots are leased, but what is the total revenue for the trust.

(4) The answer to establishing a fair market price for the lots is to offer up the "dozens" of vacant lots DNRC currently has for largely unrestricted bid.[32] With no minimum bid specified, Illi believes the market will determine a full market rental rate for these properties. This rate information could then be expanded to develop market value rental rates for other state leases.(Illi, p.4)

The Illi report, through this recommendation further confuses the concepts of seeking the "market clearing price" at which all leases have bidders, and the "revenue maximizing price" that provides the constitutionally mandated maximum returns to the beneficiaries. While DNRC offering up a significant number of lots for largely unrestricted bidding might indeed result in all lots being leased, applying these new market clearing lease rates to other existing leases would likely significantly reduce the annual stream of revenues from state cabinsites.

As with any good or service, the market for cabinsite rentals can be represented by a downward sloping demand curve. Demand for essentially any good or service is represented by this downward sloping curve reflecting the fact that any given good or service may be valued more or less highly by different consumers. As the price of a product (such as a cabinsite lease) increases fewer consumers are willing to bid on the lease. As the price drops, more consumers are willing to bid on the lease. This relationship is important when anticipating the result of the solution proposed by Illi.

Currently DNRC has the vast majority of their cabinsites in active leases. There are about 90% of available lots currently leased. There may be a number of other leaseholders who would also choose

[31] Personnel communication, Michael Sullivan DNRC. August 2011.
[32] Illi suggests a minimum rate of ¾ of one percent or $1,000, whichever is greater.

to leave their leases if they could sell their improvements for the price they are asking, but still, a very large majority of cabinsite lots are currently leased. As demonstrated by their actions, many of these lessees are willing to accept and pay the current 5% using the adjusted value under Alternative 3B. The nature of demand theory also implies that some of current lessees would be willing to pay even higher rates if that was the market price.

Any lots that were put on the market in an effort to set prices through competitive bidding would be "on the margin." That is, those who have sought out state leases and value these leases most highly, are already in active leases. Since there is indeed a significant vacancy rate for lots at the current time, it is axiomatic that the competitively bid rates for any new lots placed up for bid will be below current contract rates (all other factors remaining the same). This is not a new unexpected revelation about the market value of all cabinsites, but only about those offered for bid on the margin, when the most highly valued demand has already been satisfied. Extrapolating these new bid rates to existing leases would have the effect of reducing the revenue collected from lessees who have through their market transactions shown a willingness to pay at the higher rate.

A less abstract example might be a store that has 500 computers to sell for $500 each. Say that they sell 475 of these for the asking price. With the 25 remaining, they ask for bids and receive an average bid of $325 per computer. Under the general process seemingly suggested by Illi, the store should sell the last 25 computers for $325 each and then refund $175 ($500-$325) to each of those 475 customers who were perfectly willing previously to pay the original $500 price. Of course a profit maximizing store would not operate this way. Neither is this type of process consistent with a revenue maximizing trust relationship.

(5) Illi cites the Moe et al. (2009) Idaho study discussed above as evidence that rental rates should be significantly below 5% of appraised value.(Illi p. 5)

The Idaho Moe et al. (2009) report has been discussed above. The authors of that report presented it as only a suggestion of a methodology that could be used in setting lease rates. Moe et al. stressed that the results presented did not represent their final opinions on lease rates. Additionally, there are significant and fundamental theoretical problems with application of the Moe et al. model to cabinsite leases (Anderson & Watson 2010a) whether in Idaho or Montana.

3.6 Analysis of Impact of Vacancy Rate Trends

One concern highlighted in the DNRC (2009) report related to full implementation of lease rates of 5% of 2009 appraised values was that a large number of leases would be vacated and total revenues to the trust would decline over what had been collected under lower lease rate structures.

DNRC did a good analysis of this possibility and found that a full 18.8% **of the highest valued leases** would have to be vacated in order for total trust revenues from cabinsite leases to fall below the level implied by using 5% of 2003 appraised values as a method of setting lease rates.

Figure 12 shows a comparison of state cabinsite vacancy rates (based on the maximum number of sites rented in 1996) and statewide vacancy rates for homes and rental units.[33] The data for statewide home and rental vacancy rates are limited to the 2004 to 2009 time period. Since the cabinsite leases are often a split-ownership situation (with the lessee owning the improvements and the trust owning the land), they occupy an ownership position somewhere between a home and a rental. Consistent with this is the 2004-2009 data showing cabinsite lease vacancy rates generally between home and rental vacancy rates for the state.

Since cabinsite vacancy rates have tracked home and rental rates in general proportion in recent years, one conclusion regarding the current spike in vacancy rates for cabinsites might be that it is as much reflective of general local economic conditions as of unsustainable increases in lease fees.

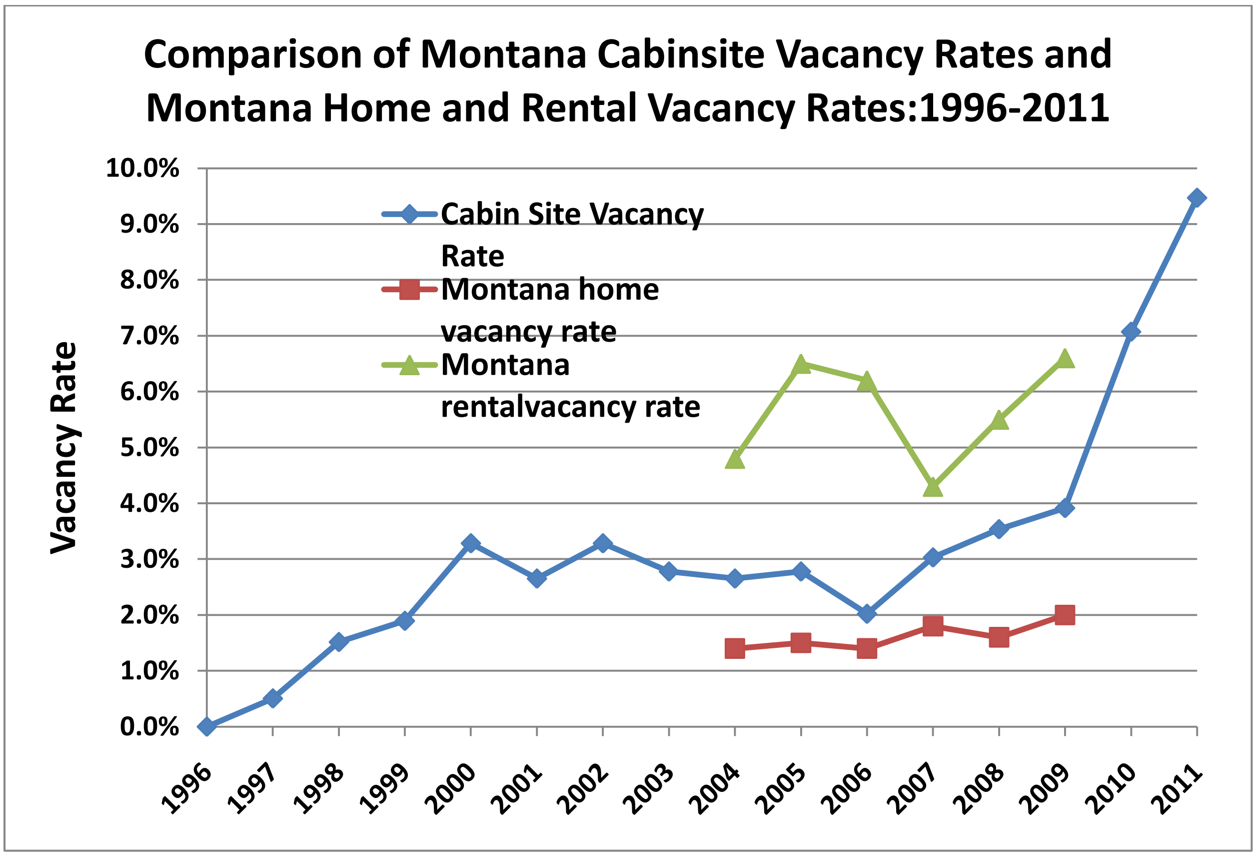

FIGURE 12. COMPARISON OF DNRC CABINSITE VACANCY RATES AND STATE OF MONTANA HOME AND RENTAL VACANCY RATES.

[33] State and local vacancy rate data are presented by the Department of the Census at http://fastfacts.census.gov/servlet/ADPGeoSearchByListServlet?_lang=en&_ts=331831011737

The 2011 vacancy rate is 9.5% for leases. The graph makes it clear that there has been a significant increase in vacancies in the last two years. These vacancies however are likely a function of many factors, including the lease rate/fees, costs of substitute properties/opportunities, the unemployment rate, and average household net worth. At this point the data on cabinsite vacancies does not support development of an explanatory model of vacancy rates as a function of lease rates/fees.

One additional perspective in interpreting cabinsite vacancy rates is provided by foreclosure rates. The greatest number of new lease vacancies for cabinsites has occurred in the last two years in the Northwest Land Office area. This finding is consistent with foreclosure statistics which show Flathead County, MT as having the highest home foreclosure rate in the state. As of August 2011, nearly 1% of Flathead County homes are in some stage of foreclosure.[34] Therefore, higher vacancy rates in this area may at least in part be merely reflective of broader or even local economic conditions, rather than only current lease rates.

3.7 Analysis of Potential Impacts of SB 409

The 2011 Montana Legislature passed into law SB 409. This bill was a bipartisan attempt to address some of the issues associated with rapidly rising lease charges for cabinsites (the final text of SB 409 is included in Appendix A). A central feature of this bill is the establishment of an open competitive bidding process with an initial minimum bid rate set at 2% of the most recent site appraisal value. This rate could be lowered incrementally if no qualifying bids are received within 180 days, until a bid is received.

In many respects the rate-setting process in SB409 is very similar in its characteristics to that proposed by Illi (2010), and discussed above. SB409 directs the state

> *(ii) The final rental market percentage determined for each geographic location pursuant to this subsection (1)(b) must be applied to the department of revenue's most recent appraised value for each cabin site property in that location that did not go through the open competitive bidding process to determine the initial lease amount for each cabin site property. (SB409, Section 2(b)(ii))*

The short-term impact of this "resetting" of lease rates (to assumed lower levels) based on the competitive bidding process would likely be multifaceted. The lower rates would give relief to leaseholders and perhaps allow some of them to continue with their leases rather than abandoning

[34] www.realtytrac.com/trendcenter/mt/flathead-county-trend.html Accessed August, 2011.

them and selling their improvements. The lower rates would also result in a drop in trust revenues per lease, and most likely a drop in aggregate lease revenues.

A second aspect of the SB409 requirements is that leases must be offered at the new competitively bid rate for a minimum of 15 years and that the total annual fee shall be indexed annually using the consumer price index published by the U.S. Bureau of Labor Statistics (SB409, Section 1(b)(iii & iv)). In the long term tying these minimum 15-year leases to the CPI could lead to significant reductions in trust revenue compared to using updated DOR appraisals as a basis for indexing fees. As reported in DNRC (2009), the average annual land appreciation rate for Montana for the period 1975 (Q1) to 2009 (Q1) was 6.14%.[35] By comparison, the average annual increase in the CPI-U over the same period has been in the range of 3.4%.[36] Should this relationship hold true into the future, at the end of a 15-year lease term, the annual lease fee on a cabinsite would only be approximately two-thirds under the CPI indexing as it would be based on appraised lot values. Of course, actual future inflation rates and land values are unknown. However, it is clear that adoption of the CPI indexing 15 years ago would have resulted in significantly lower lease fees than are paid currently by lessees.

Based on the examples and studies referenced in this report, it is clear that the minimum initial bid level for competitive bidding of 2% is well below current rates charged in parallel settings (Knipe & Knipe (2009); Anderson & Watson (2010a and b); DNRC (2009)).

3.8 DNRC Alternative 3B

Section 1.2.2, above, discusses the DNRC Alternative 3B for setting and escalating lease fees. Alternative 3B addresses a number of problematic aspects of the current cabinsite leasing program. As was discussed in Section 3.6, vacancy rates have risen significantly in the past three years. This is likely a result of a combination of factors including rising unemployment, rising land values (over the 2003-2009 period), implementing new lease fees based on new land values, and lower average household assets. Because the increase in vacancy rates is a relatively new issue, and due to the very unique and challenging economic climate that has also existed over the past three years, it is not possible to determine the extent to which increasing lease fees are responsible for new vacancies or whether other factors are primarily responsible. One possibility is that as the economy recovers from its downturn and the next appraisal cycle gets underway, that vacancies will slow or stop, and demand for vacant lots will increase. A second possibility (although contrary to the preponderance of evidence) is that a rate that is a full 5% of appraised value is higher than the revenue maximizing rate for the properties.

From a perspective of caution, Alternative 3B appears to recognize the short-term uncertainty in the cabinsite lease market and offer a reasonable solution, using an adjusted appraised value along with

[35] DNRC (2009) p. 11, citation of FHFA House Price Index for Montana.
[36] http://data.bls.gov/cgi-bin/surveymost?cu Accessed August 2011.

somewhat predictable lease fee increases over a 15-year period. This policy while leading to the same endpoint as applying a full 5% rate today to current lot values allows for a gradual, more orderly process. As contract rents using 2003 appraisal values conclude by January 2013, DNRC and the Land Board can monitor vacancy rates and revenues in detail over a number of years, and (hopefully) in improving economic conditions to further understand the relationship between lease rates and trust revenue.

This alternative has two advantages from the perspective of the trustees and beneficiaries: 1) using an adjusted appraised value reduces the likelihood that rates being set too high resulting in mass abandonment of leases and a significant drop in total lease revenue in the near term, and 2) when compared to a policy of lowering lease rates for all lessees in order to prevent further lease vacancies, Alternative 3B does not lower rates for the large number of lessees who have already shown a willingness and ability to pay the rates as they are currently projected in Alternative 3B’s first fifteen-year term. Both of these advantages are consistent with a policy of protecting and maximizing lease revenues.

4.0 CONCLUSIONS AND LIMITATIONS ASSOCIATED WITH CABINSITE LEASE RATE ANALYSIS

4.1 Summary Conclusions

This analysis has examined data and reports relating to Montana and Idaho cabinsite leasing rates and rate setting. Additionally, we have examined current and recent lease rates for similar trust lands as well as for rental lands in comparable settings. We have examined appropriate lease rates implied by Montana lease transfers, from competitive bidding for leases, and from historical vacancy rates for leases. Finally, we have reviewed both current and recently passed lease rate policy in Montana. The following conclusions are based on this analysis.

1. Analysis of cabinsite transfer data for the period from 2003 through August 2011 suggests that many lease sales still result in positive leasehold value to the seller. This indicates that the full market rental rate is above the contract rental rate. In the most recent years' data (2010-2011), the implied full market lease rate from the transfer is in the range of 5% to 7%.
2. Analysis of competitively bid leases provides an inconclusive picture of current competitive market rates. While some (7) leases have been bid at above the minimum (5% of adjusted 2003 value) rate, several other lots have been offered for lease and received no bids in the past few years. Additionally, DNRC maintains a list of currently vacant lots available for bid. Taken together this data indicates that current rates are not low enough in the current economic climate to ensure that all lots offered for lease receive bids. However, this does not imply that the current rates are inconsistent with a policy of revenue maximization for the trust.
3. Past and current examples of recreational lot leases by state trusts, the federal government, and corporations and utilities support the conclusion that market lease rates are generally above 5%.
4. Vacancy data for Montana cabinsites indicate that vacancies have increased significantly in the past three years, particularly in the areas managed by the Northwest Land Office (Kalispell). The data is not sufficient, however, to draw conclusions as to the likely trend and future vacancy rates and their impact on trust revenues.
5. SB409, while likely reducing cabinsite vacancies, has the potential to lower both current trust revenues and the rate at which those revenues grow in the future.

4.2 Study Limitations

This study is intended to provide an overview and updating of methods developed and conclusions reached regarding appropriate Montana cabinsite lease fees in the Duffield (1993) report. The Duffield methods and updated data were supplemented with reviews of studies, documents, and comparable examples relating to residential recreational lot leases in both Montana and Idaho. Substantial uncertainty exists regarding economic conditions (including unemployment, wage growth, and real estate values) in the near term. The conclusions from this analysis are necessarily backward-looking based on available data. To the extent that Montana economic activity were to decline or stagnate for several more years, conclusions in this report from the analyses of lease transfers, competitive bids, and vacancy rates may marginally overstate the true revenue maximizing lease rate. Conversely, a return to comparatively robust economic times may result in a future situation where a 5% lease rate is below the long term revenue maximizing level.

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APPENDIX A: TEXT OF MONTANA SB 409

62nd Legislature SB0409

Authorized Print Version - SB 409

AN ACT GENERALLY REVISING STATE LAND CABIN SITE LAWS; AUTHORIZING AN ALTERNATIVE RENTAL MARKET VALUATION COMPETITIVE BID PROCESS; AUTHORIZING THE SALE OF STATE-LEASED CABIN OR HOME SITES OR CITY OR TOWN LOTS; PROVIDING RULEMAKING AUTHORITY; AMENDING SECTIONS 77-1-208, AND 77-2-318, MCA; REPEALING SECTION 77-2-319, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Alternative rental market valuation -- open competitive bidding process. (1) (a) In order to establish full rental market value, the board shall establish an open competitive bidding process for all vacant cabin site properties. Except as provided in subsection (1)(c), the minimum bid must be initially set at 2% of the most recent cabin site appraisal value as determined by the department of revenue.

(b) (i) The board shall, within 180 days from the date that a cabin site property becomes vacant, put that site up for open competitive bidding.

(ii) In providing notice of the open competitive bidding process, the board shall notify prospective bidders that a bidder other than the current lessee or licensee is obligated to purchase the improvements pursuant to 77-1-208(4) if that bidder offers the highest bid.

(iii) A lease or license term for a bidder that offers the highest bid and acquires a lease or license must be for a minimum period of 15 years.

(iv) The fee for each subsequent year must be adjusted using the average annual consumer price index as published by the U.S. bureau of labor statistics.

(c) If pursuant to subsection (1)(a) the board does not receive the minimum bid within 180 days, the board may reduce the bid incrementally until a bid is received.

(2) Subject to [section 2], a lessee or licensee may voluntarily put the lessee's or licensee's cabin site up for open competitive bid as provided in subsection (1) of this section. A lessee choosing to voluntarily place a cabin site lease up for competitive bid is not entitled to a preference right to meet the high bid. Prior to the open competitive bidding process, the board shall follow the procedures provided in 77-1-208(3) to establish the market value of improvement.

(3) By January 1, 2012, the board shall adopt rules to ensure that:

(a) the open competitive bidding process authorized pursuant to this section is orderly and consistent with the board's constitutional fiduciary duties and that the number of leased cabin or home sites or city or town lots made available for competitive bid at any given time is consistent with the board's constitutional fiduciary duty of attaining full rental market value; and

(b) the information used to determine the rental market percentage pursuant to this section is posted on the department's website and periodically updated.

Section 2. Rental market valuation lease program -- transition. (1) (a) Subject to subsection (2), the board shall offer all existing cabin site lessees or licensees the option of 15-year lease contracts based on the rental market valuation process provided in [section 1].

(b) (i) At least three winning bids made pursuant to [section 1] must be referenced against the most recent appraised value of the cabin site property by the department of revenue in order to establish a rental market percentage. All rental market percentages that have been determined pursuant to [section 1] must be grouped together by geographic location and averaged together to determine a final rental market percentage for each geographic location. If there are not three winning bids in any one geographic location, then three bids from similar locations may be averaged to establish a rental market percentage.

(ii) The final rental market percentage determined for each geographic location pursuant to this subsection (1)(b) must be applied to the department of revenue's most recent appraised value for each cabin site property in that location that did not go through the open competitive bidding process to determine the initial lease amount for each cabin site property.

(c) If no properties in a particular geographic location go through an open competitive bidding process, the most applicable comparable location, as determined based on professional appraisal standards, must be chosen and the final rental market percentage must be applied as provided in subsection (1)(b).

(2) The lease amount for the first year must be set as provided in subsection (1). The annual lease rental fee for each subsequent year must be adjusted using the average annual consumer price index as published by the U.S. bureau of labor statistics.

(3) By January 1, 2012, the board shall adopt rules for the orderly transition for cabin site lessees or licensees who have chosen the lease option pursuant to subsection (1) that is consistent with the board's constitutional fiduciary duty of attaining full rental market value.

(4) Nothing in this chapter prevents:

(a) an existing lessee or licensee from completing or renewing the lessee's or licensee's current lease or license based on existing methods of valuation as provided in 77-1-208; or

(b) a lessee or licensee that has abandoned a lease or license from bidding on the abandoned lease or license.

Section 3. Section 77-1-208, MCA, is amended to read:

"77-1-208. Cabin site licenses and leases -- method of establishing value. (1) The board shall set the annual fee based on full market value for each cabin site and for each licensee or lessee who at any time wishes to continue or assign the license or lease. The fee must attain full market value based on one of the following methods:

(a) appraisal of the cabin site value as determined by the department of revenue. The licensee or lessee has the option to pay the entire fee on March 1 or to divide the fee into two equal payments due March 1 and September 1. The value may be increased or decreased as a result of the statewide periodic revaluation of property pursuant to 15-7-111 without any adjustments as a result of phasing in values. An appeal of a cabin site value determined by the department of revenue must be conducted pursuant to Title 15, chapter 15.

(b) establishing full rental market value through the use of an open competitive bidding process as provided in [section 1].

(2) A current licensee or lessee may complete or renew the licensee's or lessee's current lease based on valuation methods provided in subsection (1)(a), or at the end of the lease or license contract, the licensee or lessee may choose to proceed with the valuation option provided in subsection (1)(b).

(3) The board shall set the fee of each initial cabin site license or lease or each current cabin site license or lease of a person who does not choose to retain the license or lease. The initial fee must be based upon a system of competitive bidding. The fee for a person who wishes to retain that license or lease must be determined under the method provided for in subsection (1).

(4) (a) Subject to subsection (4)(b), the board shall follow the procedures set forth in 77-6-302, 77-6-303, and 77-6-306 for the disposal or valuation of any fixtures or improvements placed upon the property by the then-current licensee or lessee and shall require the subsequent licensee or lessee whose bid is accepted by the board to purchase those fixtures or improvements in the manner required by the board.

(b) (i) A subsequent licensee or lessee may not take occupancy unless the license or lease contract and the sale of improvements have been finalized. If a winning bidder has been identified and the transaction for the sale of the improvements is in process, the current lessee shall pay a prorated lease fee based on the current lease until the date that the sale of the improvements is finalized.

(ii) The valuation of improvements must be applicable to residential property inclusive of all improvements.

(iii) A licensee or lessee may assign or rent any improvements.

(iv) Within 3 years of canceling, terminating, or abandoning a cabin site lease, the owner of the improvements shall sell the improvements, remove the improvements, or transfer ownership of the improvements to the state. If ownership is transferred to the state, proceeds from the sale of the improvements must be paid to the owner who transferred the improvements. The board shall set the conditions of the sale of transferred improvements in order to sell the improvements in an expedient manner."

Section 4. Section 77-2-318, MCA, is amended to read:

"77-2-318. Sale of leased cabin or home sites or city or town lots. (1) At the request of the lessee and if consistent with the orderly development and management of state lands, the board may make available for sale, in the manner provided in this part, any leased cabin or home site or city or town lot that is under lease during the 15th year of any 15-year lease that was established through the open competitive bidding process or through the transition process provided for in [section 2] or subsection (4) of this section.

(2) The lessee requesting the sale shall have prepared a current certificate of survey for the property. The cost of preparation of the certificate of survey must be included in the settlement for improvements, as provided for in 77-2-325, if a person other than the lessee is the purchaser.

(3) The sale of a lease is exempt from the subdivision laws, except that the development of any new, replacement, or additional water supply or sewage disposal system on the property must be approved pursuant to the review procedure, fee, and other requirements of Title 76, chapter 4, part 1.

(4) By January 1, 2012, the board shall adopt rules to ensure that the sales process authorized pursuant to this section is orderly and consistent with its constitutional fiduciary duties and that the number of leased cabin or home sites or city or town lots made available for sale at any given time is consistent with the board's constitutional duty of attaining full market value.

(5) Upon a sale of leased land, the department shall, upon compliance with 77-2-101 through 77-2-106, grant a permanent easement across state lands to secure access using current routes."

Section 5. Repealer. The following section of the Montana Code Annotated is repealed: 77-2-319. Conservation easement for certain sales.

Section 6. Codification instruction. [Sections 1 and 2] are intended to be codified as an integral part of Title 77, chapter 1, part 2, and the provisions of Title 77, chapter 1, part 2, apply to [sections 1 and 2].

Section 7. Effective date. [This act] is effective on passage and approval.

- END -

SB0409

APPENDIX B: BIDDING PROCESS ON DNRC LEASES

Source:

http://www.dnrc.mt.gov/cabinsite/default.asp

To bid on an ACTIVE lease:

1) Active cabinsites are being bid upon at this time and bids are due by the date indicated in the Bid Closing Date column.

2) Download the bid package. The bid package includes information on the improvements (if any), Lease Application Form, Lease Bid Form, minimum bid amount, Bid Closing Date and more.

3) Fill out both the Lease Application Form and Lease Bid Form. Send both forms to the address provided, along with the non-refundable lease application fee and 10% bid deposit.

4) Your bid and lease application must be arrive at DNRC no later than 5:00 p.m. on the Bid Closing Date to be eligible for consideration.

5) Upon close of the bidding period, all bidders will be informed of the results of the competitive bidding, and the highest bidder will be provided an opportunity to enter into a lease for the cabinsite.

To bid on an INACTIVE lease:

1) The status of Inactive cabinsites may be changed to Active on request. To bid on an Inactive lease, download the bid package. Fill out the Lease Application Form only and send the form to the address provided along with the non-refundable $25.00 lease application fee.

2) Upon receipt of a completed Lease Application Form, DNRC will change the table above to show the cabinsite status as Active and provide the Bid Closing Date. You will receive confirmation from DNRC that your application was received and that cabinsite bidding has been opened.

3) If you wish to proceed with bidding, you must have a Lease Bid Form and 10% bid deposit to DNRC by 5:00 p.m. on the Bid Closing Date to be eligible for consideration.

To bid on a PENDING lease:

Cabinsites shown as Pending are currently vacant but for one or more reasons are not ready to be offered for bid at this time. If you have a strong interest in one of these sites, please contact the DNRC at 406.444.2074 as the agency may be able to accommodate leasing interest by getting the cabinsite ready for bidding and moving it to an Active status. The minimum bid shown for lots with a Pending status has not been verified. The minimum bid shown is for general informational purposes only and may change following final review by the Department.

To purchase improvements:

It is recommended you contact the improvements owner before you bid to arrange for the purchase of improvements. The contact information for the improvements owner is provided in the bid package.

The improvements on the cabinsite, if any, are owned by the former lessee. The new lessee shall pay the improvements owner the reasonable value of the improvements. If the high bidder does not wish to purchase the improvements, that bidder will be disqualified and DNRC shall award the lease to the next highest qualified bidder, or rebid the lease.

Once a lease has been signed by the successful bidder, the DNRC will notify the improvements owner that there is a new lessee of the cabinsite. The new lessee and the improvements owner will have 120 days from the date DNRC sends notice to the improvements owner to provide to DNRC the necessary documentation confirming that the new lessee and the improvement owner have settled on the improvements. Documentation evidencing that the improvements have been properly settled to the satisfaction of both parties may include a deed granting ownership to the new lessee, an agreement stipulating both parties have reached a price and shall close the sale on a specified date, or notice that the improvements shall be removed from the site.

If the DNRC does not receive documentation within 120 days, the department will conclude that the parties cannot agree upon a reasonable value and DNRC will initiate an arbitration process as provided in 77-6-306, MCA to ascertain and fix the price for the improvements. The DNRC may delay arbitration by 30 days if the parties are close to agreeing upon a value. The former lessee may initiate arbitration at any time following notification that there is a new lessee of the cabinsite. The value determined through arbitration shall be binding on both parties, subject to appeal as provided in 77-6-306, MCA. The new lessee shall pay the former lessee for the improvements per the terms of the arbitration settlement, or if not specified, within 30 days after the value has been fixed by arbitration.

APPENDIX C: ADMINISTRATIVE RULES OF MONTANA (ARM) PERTAINING TO CABINSITE LEASES

36.25.1001 CABINSITE DEFINITIONS

(1) "Abandon" or "abandonment" means the simultaneous intent and voluntary act of surrendering or disclaiming any ownership of, or surrendering or disclaiming a property interest in a lease or the improvements existing upon a lease, or both.

(2) "Adjusted 2009 appraised value" means an amount equal to the 2003 Montana Department of Revenue (DOR) appraised value for a state parcel increased at a rate of 6.53 percent compounded annually to 2009.

(3) "Annual lease rental period" means March 1 to February 28, annually.

(4) "Assignment" means the transfer of rights, obligations, and ownership of a current lease agreement to another person or other legal entity qualified to hold a lease.

(5) "Base rent" means the lower of five percent of the adjusted 2009 appraised value of the state trust land under lease or an amount equal to five percent of the actual 2009 reappraisal of market value by the DOR.

(6) "Board" means the Board of Land Commissioners.

(7) "Cabinsite", also referred to as "homesite" and "residential lease", means land occupied or to be occupied for a noncommercial use as a temporary or principal place of residence for a single family or equivalent of the same, and the supporting buildings, within the lease area.

(8) "Cancellation" means an involuntary nullification or voiding of rights under a lease before the end of its stated term due to a breach of the lessee's obligations under the lease contract.

(9) "Consumer Price Index" (CPI) is a measure of the annual change in the price of a basket of consumer goods over time. For these rules, the department will use the CPI-U, West Urban Index published by the U.S. Bureau of Labor Statistics (http://www.bls.gov/) or, should the CPI-U, West Urban Index be discontinued, a similar index published by the U.S. Bureau of Labor Statistics chosen by the department. The CPI shall be established by reviewing the annual change in the CPI on October 1 of each year.

(10) "Department" means the Department of Natural Resources and Conservation.

(11) "Director" means the director of Natural Resources and Conservation, chief administrative officer of the Department of Natural Resources and Conservation, or the director's designee.

(12) "Lease" means a contract by which the board conveys state trust land for a term of years for a specified rental, and for the use for which the land is classified (77-1-401, MCA).

(13) "Lease fee adjustment" means the department application of the rental rate contracted in the lease to the most recent appraised market value to determine if it is necessary to alter the annual rental payment. The adjustment will occur at the review period defined in the lease.

(14) "Lease fee adjustment process" means the annual process by which the department applies the Lease Fee Indicator to the adjusted 2009 appraised value of the leased premises, or by which the department applies the rental rate contracted in the lease to the actual 2009 reappraisal of market value by the DOR, and subsequent reappraisals, to determine if it is necessary to alter the annual rental payment. Future lease fee adjustments will occur at the review period defined in the lease, or at any time that it is considered necessary to protect the interests of the trusts, as determined at the sole discretion of the director of the department.

(15) "Lease Fee Indicator" (LFI) means the increase that is applied annually to the previous year's lease fee. The LFI, which is recalculated annually, is the average of the CPI and the Real Estate Index; however, the LFI shall be limited in that it may never be less than 3.25 percent and may never be more than 6.5 percent. The LFI is named for the year the CPI data was primarily collected, but applied to the billing for the following year. For example, an LFI determined from CPI data from calendar year 2014 would be called the 2014 LFI and would be applied to the 2015 cabinsite lease fee adjustment process.

(16) "Real Estate Index" (REI) means a moving 25-year average of the annual appreciation of all cabinsite parcel values. This number will be adjusted after every new reappraisal cycle by the DOR. The REI is currently 8.75 percent and will remain so until the next DOR appraisal, which is currently scheduled for 2014.

(17) "Security interest" means an interest that a third party retains in any portion of a lease and the lease improvements located on that lease in order to secure the payment by the lessee to that third party.

(18) "Semiannual lease rental period" means March 1 to August 31 or September 1 to February 28.

(19) "Trust(s)" means any one, or collectively all of the trusts, that receive income derived from department management of state trust lands.

36.25.1002 CABINSITE LEASES

(1) A cabinsite lease may only include a maximum of five acres unless special circumstances exist for which the department may grant more than five acres.

(2) The lessee shall be required to comply with all rules and regulations, including, but not limited to:

(a) county planning;

(b) subdivision requirements; and

(c) other state and federal statutes and regulations. The department's approval to place or modify any improvement on the lease lot does not necessarily constitute approval from any other regulatory entity such as a county, other state administrative agencies, or federal agencies.

(3) The successful bidder for a cabinsite lease may be required to pay for the cost of any surveys, fulfillment of zoning and subdivision requirements, and other assessments, or costs related to compliance with any other local, state, and federal statutes and regulations.

(4) Cabinsite leases shall be classified as per ARM 36.25.108, or if necessary, reclassified as per ARM 36.25.109.

(5) A cabinsite lease grants the lessee the right of access and the right to place necessary utility facilities within the cabinsite lease premises and across specified adjacent state trust lands from the main utility to the cabinsite lease premises during the term of the lease, with the prior written approval of the department. For any such rights outside of state trust land, the lessee will be responsible for obtaining any necessary easements from the appropriate landowner(s).

36.25.1003 CABINSITE MINIMUM RENTAL

(1) Effective January 1, 2010, and for those cabinsite leases due for the lease fee adjustment process in calendar year 2008 and 2009, and except as provided in (1)(a) and (1)(b), the minimum rental for a cabinsite lease is the greater of five percent of the 2009 appraised market value of the land, excluding improvements, as determined by the Montana Department of Revenue (DOR) pursuant to 77-1-208, MCA, or $250, or a competitive bid amount as described in ARM 36.25.1009. As required by 77-1-106, MCA, this rental rate reflects the expenses commonly incurred by lessees in leasing state trust land. A cabinsite lessee may:

(a) choose to pay rental on a cabinsite lease according to the existing terms and conditions within the current lease contract with the department; or

(b) sign and execute a 2010 supplemental lease agreement (SLA), which will direct that the minimum rental shall be calculated as follows:

(i) an amount equal to the 2003 appraised parcel value determined by the DOR, increased at an annual rate of 6.53 percent, compounded annually for six years to obtain the adjusted 2009 appraised value. [Example: 2003 appraised value multiplied by $(1.0653)^6$ equals adjusted 2009 appraised value];

(ii) the adjusted 2009 appraised value shall be compared to the 2009 appraised parcel value determined by the DOR;

(iii) the lower of either an amount equal to five percent of the adjusted 2009 appraised value or five percent of the 2009 appraised parcel value shall be the base rent applicable to the lease in the year 2010;

(iv) the annual rental due for years 2011 and thereafter shall be calculated by applying the LFI to the previous year's lease fee. Any lease renewed, reviewed, or subject to lease fee adjustment, shall pay an annual rental equal to that calculated under (b)(i) through (iv), above. In year 2010, the LFI will not be used. [Example: 2010 base rent multiplied by (1 + LFI) equals 2011 rent]; and

(v) lessees may opt to sign an SLA at any time before lease renewal.

(2) Effective for the 2025 cabinsite billing, the department will have a lease fee adjustment and review the 2024 annual cabinsite rental for each lease individually, as calculated under the provisions of (1)(b). The department will compare that cabinsite rental to an amount equal to five percent of the most recent appraised parcel value for the cabinsite lease as determined by the DOR. The difference between these two rental amounts shall be compared and described as a percentage of how much five percent of the appraised parcel value is above or below the 2024 rental as billed.

(a) If the 2024 rental, as billed, is not more than 15 percent above or below five percent of the most recent appraised parcel, then the 2025 rental will be the same as the 2024 rental.

(b) If the 2024 rental, as billed, is more than 15 percent above or below five percent of the most recent appraised parcel, then the 2024 rental will be increased or decreased by that percentage amount so it becomes identical to five percent of the appraised parcel value.

(c) The lease fee adjustment between 2024 and 2025 will not exceed a 50 percent increase or decrease.

(d) No additional LFI will be applied in determining the lease fee adjustment from 2024 to 2025.

(3) For leases that will complete their current contract rental calculation and have a lease fee adjustment, particularly those cabinsite leases due to start the lease fee adjustment process in calendar year 2011, 2012, and 2013 and beyond, the rental will be calculated per (1)(a) and (1)(b).

(4) The lease fee adjustment will occur every 15 years after the 2024 review.

(5) In the 15-year periods between lease fee adjustments, rentals will be calculated per section (1)(b).

(6) New and renewed leases will have rents calculated in accordance with (1)(b), or at the discretion of the director.

(7) Cabinsite lessees shall pay a lease rental that is the higher of the rental amounts as calculated by this rule, or the bid amount, or a minimum annual rental of $250. The lessee shall pay that higher amount until such time as the rental, as calculated by this rule, exceeds the bid amount or $250.

36.25.1004 CABINSITE PAYMENT DUE DATE

(1) The department shall bill for cabinsite leases using the schedule outlined in (1)(a) through (c).

(a) Written notice of the amount of rental due for 2010 will be sent to each cabinsite lessee's address of record following adoption of these rules on May 28, 2010. In this instance, the specific dates for payment notification, when payments are due, and when late charges and lease cancellation may occur will be approved by the Land Board.

(b) Beginning in January 2011 and each January thereafter, the department will send written notice of the amount of rental due to each cabinsite lessee's address of record.

(i) The notice shall state that the payment is due by March 1, and if payment is not received or postmarked by April 1, that the lease is cancelled.

(A) In mid-March, prior to April 1, the department shall send a reminder letter by certified mail to each lessee who has not made payment, notifying the lessee that the lease is cancelled if payment is not received or postmarked on or before April 1. If payment is not received or postmarked by April 1, the entire lease is cancelled.

(B) An additional $25 late fee will be charged for payments made after March 1, but before April 1. If payment is not received or postmarked by April 1, the entire lease is cancelled.

(c) If the lessee elects to make semiannual payments, the department will send written notices in January and July of each year, except as described in (1) to the address of record, per ARM 36.25.104(3), stating the amount of semiannual rental due.

(i) The notice shall state that the first-half payment is due by March 1, and if not paid by April 1, the lease is cancelled. The notice shall also state that the second-half payment is due by September 1, and if not paid by October 1, the lease is cancelled.

(A) In mid-March, prior to April 1; and mid-September, prior to October 1, the department shall send a reminder letter by certified mail to each lessee who has not made payment a letter notifying the lessee that the lease is cancelled if payment is not received or postmarked on or before April 1 or October 1. If payment is not received and postmarked by April 1 or October 1, the entire lease is cancelled.

(B) An additional $25 late fee will be charged for payments made after March 1 but before April 1; and payments made after September 1 but before October 1.

(d) In special circumstances, as determined by, and at the direction of the board, the department may send notices of payment to lessees at times other than those described in (1)(a) and (b). The specific dates for payment notification, when payments are due, and when late charges and lease cancellation may occur will be approved by the Land Board.

(2) A lease may be reinstated for an additional reinstatement fee, which will be a minimum of $500, or as much as three times the annual rental amount of the lease. The decision whether or not to offer a lessee the ability to reinstate the lease by paying a reinstatement fee, as well as the amount to charge for the reinstatement fee, are both at the discretion of the department.

(3) The rental price for the first year of a new lease shall be prorated by dividing the full amount of the rental for the first year by 365 then multiplying the result by the number of days between the lease start date and the last day of the upcoming February.

36.25.1005 CABINSITE IMPROVEMENTS

(1) A cabinsite lessee may place improvements on state trust land which are necessary for the conservation or utilization of that state trust land and associated structures such as outbuildings, utilities, and sleeping cabins, with the approval of the department; however, only one single-family residence will be permitted on each cabinsite lease, and the lessee is responsible to ensure all such installations and improvements meet all applicable rules, codes, and regulations.

(2) The lessee shall apply for permission prior to placing any improvements on state trust land and shall use the form prescribed by the department.

(3) A lessee will not be entitled to compensation by a subsequent lessee for improvements placed on the land after May 10, 1979, unless those improvements were previously approved by the department in writing prior to their placement upon the land. Proof of the date of placement of improvements may be required by the department. Any improvements or fixtures paid for by state or federal monies shall not be compensable to the former lessee.

(4) The lessee shall be responsible for notifying the department of the value of the improvements. The asking price of the improvements shall be the higher of either the most recent DOR assessment of the improvements, or of an appraisal of the improvements, though the lessee retains the right to lower the asking price of the improvements. Settlement for the improvements shall be determined pursuant to 77-1-208(3), MCA, and the procedures set out in ARM 36.25.125. All settlement for improvements must occur within 120 days of the issuance of the lease.

(a) If an appraisal is needed, the appraisal shall be contracted by the department and paid for by the lessee.

(b) Determination of compensation for improvements shall utilize standard appraisal procedures, giving full consideration to the improvement's condition, its contribution to the value of the property for residential purposes, and remaining economic life. Compensation shall be the estimated cost to construct, at current prices, a building with equivalent utility as of the date of the lease or license's expiration.

(5) At the time of assignment or other transfer of interest in the leasehold, the department must be notified of the sale price of the improvements and be provided copies of any agreements reflecting the transfer of both the lease and improvements, such as, but not limited to a realty transfer certificate.

(6) The department may require a written notice from the former lessee stating that the former lessee has received full compensation for the improvements or has removed the improvements and fixtures when a new lease is issued.

36.25.1006 REMOVAL OF CABINSITE IMPROVEMENTS AND COMPENSATION

(1) At cancellation, termination, or abandonment of the cabinsite lease, the lessee will be notified of their right to be compensated for their improvements by a new lessee, or their right to remove those improvements.

(2) If the former lessee informs the department that they wish to remove their improvements, the former lessee must:

(a) obtain a land use license to remove the improvements. The land use license may be for a term up to 60 days. The term may be extended by the department for good cause; and

(b) pay the license fee in advance. The license fee will be calculated as the most recent year's lease fee, divided by 365, and multiplied by the number of days in the license. The minimum fee for a removal land use license shall be $50.

(3) If the former lessee informs the department that they wish to be compensated for their improvements by a new lessee, the former lessee will have a maximum of three years from the time of cancellation, termination, or abandonment of the cabinsite lease to be compensated for their improvements by a new lessee. The former lessee shall have:

(a) submitted in writing to the department a statement that the former lessee is seeking third-party compensation for the improvements;

(b) paid all property taxes and any applicable special assessments; and

(c) provided the department with qualifying value information for the improvements. At any time during the three-year period and at the approval of the department, the former lessee may request a license to remove the improvements, at a fee and duration consistent with this rule.

(4) The beginning of the three year time period shall be either:

(a) the effective date of an abandonment form executed by the lessee and accepted by the department; or

(b) the date rent is due, if the rent is not paid as per ARM 36.25.1004 or no abandonment form is submitted.

(5) If the lessee abandons the improvements there shall be no obligation by the department or other party for compensation for all improvements on the property, including movable and nonmovable improvements, as well as personal property.

(6) The department reserves the right to withhold authorization to remove the improvements during any time that a lease is being actively bid by the department.

(7) If three years after the cancellation, termination, or abandonment of the cabinsite lease no new lessee has been found, the department shall provide written notice to the former lessee that unless the improvements are removed within 60 days, the improvements will become the property of the trust. This condition and limitation applies to all improvements on the property, including movable and nonmovable improvements, as well as personal property.

(8) If the department receives no written request from the former lessee seeking to receive compensation for improvements from a new lessee or to remove the improvements, the department shall seek a new lessee for the cabinsite lease.

(9) Final determination of settlement for improvements will be conducted in accordance with statutes and rules pertaining to arbitration.

36.25.1007 ACCESS TO CABINSITE IMPROVEMENTS ON AN INACTIVE LEASE

(1) A former lessee who has provided to the department a request to receive compensation from a new lessee for the former lessee's improvements, must obtain a land use license from the department to access the cabinsite for the limited purpose of maintaining the improvements and the lot and to market the improvements to a new lessee. The former lessee may not occupy the cabinsite or utilize the cabin site for recreational or residential purposes.

36.25.1008 CANCELLATION AND ABANDONMENT OF CABINSITE LEASES AND SECURITY INTERESTS

(1) The department may cancel a lease for nonpayment of rentals or any other breach of the lease contract.

(2) A lessee may request to abandon the lessee's right, title, and interest in the improvements on a cabinsite lease and the cabinsite lease itself to the department.

(a) The department reserves the discretion whether to accept the abandonment of the improvements and lease.

(b) All such abandonments shall utilize a form as prescribed by the department.

(3) Before any cancellation or abandonment of a cabinsite lease, the department shall notify any holder of a security interest form issued by the department of the impending cancellation or request by the lessee for abandonment.

(4) Abandonment of the lease begins on the date specified on the abandonment form. At such time the former lessee will forgo all rights to the lease, and if specified on the form, will forgo all rights to all improvements on the property. Abandonment of improvements means all movable and nonmovable improvements, as well as personal property.

(5) The cancellation date of the lease begins on the date specified by the department when the cancellation process is complete.

(6) After the lease is cancelled or abandoned, the lease shall be available for lease to a third party and the department may put the lease lot up for bid.

(7) The former lessee may or may not choose to market the improvements for sale. In no case will the department pay any realtor fees or commissions for the marketing of former lessee improvements when such marketing services are contracted by the lessee.

(8) The proposed buyer of a former lessee's improvements must still participate in, and be the successful bidder of the cabinsite lease, per ARM 36.25.1009.

(9) If the lease improvements have been abandoned, the improvements may be sold to a new lessee at a price determined by the department.

(10) The former lessee shall not be entitled to any refunds of any lease payments related to cancellation or abandonment.

36.25.1009 ISSUANCE OF CABINSITE LEASE ON UNLEASED AND RECLASSIFIED LAND

(1) A person who desires to lease unleased state trust land for a cabinsite must apply on the standard application form prescribed by the department. The application form must be returned to the department and must be accompanied by a nonrefundable application fee. Such application shall be deemed an offer to lease land for a cabinsite as specified by the application, at a rental rate which reflects fair market value.

(2) When the department receives one or more applications to lease a cabinsite on an unleased tract of land, or on a tract which has been reclassified, it may advertise for bids on the tract and shall use the procedures set forth in this rule. The department has the discretion to put cabinsite leases up for bid even without first receiving any applications or offers for those cabinsite leases.

(3) The department will advertise cabinsites for bid in one or more of the following ways:

(a) at least once in a newspaper of general circulation, which services the area where the cabinsite is located;

(b) at least once in any newspaper, magazine, trade journal, flier, or other print medium that potential cabinsite bidders may view;

(c) sending letters to interested parties;

(d) sending e-mails to interested parties; and/or

(e) placing information on the internet.

(4) Nothing in this rule shall preclude the department from generally making it known that a cabinsite is currently unleased and that the department is accepting applications to lease state trust land for a cabinsite.

(5) All bids shall be submitted at a specific place and time as specified by the department. Bids may be sealed bids, oral auction, or submitted electronically, whichever is indicated by the department at the time it advertises for bids.

(6) All competitive bids for cabinsites shall be submitted in the form of dollars per year. In no case may a bid be considered qualified if it is less than the minimum rental specified in the bid solicitation.

(a) For a bid to be considered, the bid must:

(i) include the bid application and application fee;

(ii) include a bid deposit that is ten percent of the amount the bidder bids; and

(iii) meet any other requirements as specified in the bid solicitation.

(b) The department will specify whether the application fee and the bid deposit may be in the form of a cashier's check, money order, or from a credit card or similar electronic funds transfer for electronic bids.

(7) The cabinsite will be leased to the highest qualified bidder, with the following qualifications:

(a) if the board determines that the bid is not in the best interests of the trust and the high bid is rejected, the board will issue its reason for the rejection in writing. The lease may then be issued, at a rental rate determined by the board, to the first bidder who is willing to pay the board-determined rental, whose name is selected through a random selection process from all bidders for the cabinsite lease; or

(b) if no bidder is selected, or if the highest qualified bidder declines the bid, the department may determine if and when to reopen a lease for bid, or offer the cabinsite lease to the next highest qualified bidder at that next bidder's bid amount.

(8) The successful bidder shall sign and return the lease to the department within 30 days of receipt of the lease. If the lease is not signed and returned to the department within 30 days, the bidder shall forfeit the bid deposit, and the department may:

(a) readvertise the lease for bid;

(b) offer the lease to the next highest bidder acceptable to the department; or

(c) choose to offer the lease for bid at a later time.

(9) The rental price for the first year of a new lease shall be prorated by dividing the full amount of the rental for the first year by 365 then multiplying the result by the number of days between the lease start date and the last day of the upcoming February.

(10) When a lease is cancelled, abandoned, or otherwise terminated, the department shall attempt to lease the land in accordance with this rule.

(11) Any former lessee who has had a cabinsite lease cancelled and not reinstated by the board or department for nonpayment of rentals may bid upon that cancelled lease, or any other cabinsite lease provided that before the bid:

(a) the former lessee pays the unpaid rentals billed for that cancelled lease;

(b) if the former lessee is bidding on that cancelled lease, the former lessee must pay any unpaid taxes or similar assessments on the improvements; and

(c) the bid is in compliance with this rule.

(12) Any lessee who has had a cabinsite lease cancelled and not reinstated by the board or department for any reason other than nonpayment of rentals may be allowed to bid; however, the board or the department may reject any or all bids for a cabinsite from a lessee who has had a cabinsite lease cancelled in the past.

36.25.1010 TERM OF CABINSITE LEASE

(1) A cabinsite lease will be issued for a period not to exceed 15 years unless the cabinsite lessee demonstrates a need for a longer period for loan security purposes, in which case the new lease may be issued in the discretion of the department for a period up to five years longer than the term of the loan up to a maximum lease period of 35 years.

(a) Demonstration of need shall be in the form of a request from the lender asking for the extended lease term.

(b) A cabinsite lease shall expire on February 28, thirty-five years or less from the beginning date of the lease.

(c) Lease terms longer than 15 years are intended for loan security of dwelling improvements, not ancillary improvements such as septic tanks, wells, garages, and outbuildings.

(d) The loan amount shall be a minimum of 15 percent of the value of the dwelling improvements.

(e) The lender shall provide proof of the loan and the loan terms to the department.

36.25.1011 RENEWAL OF CABINSITE LEASE AND PREFERENCE RIGHT

(1) A current cabinsite lessee shall be sent an application to renew the cabinsite lease if all rentals due are paid. The application shall be accepted under the same conditions as specified in ARM 36.25.115; however, applications for renewal will only be accepted after December 1 of the year preceding the expiration of the lease and must be postmarked on or before January 28 of the year of expiration of the lease. Failure to submit a renewal application postmarked on or before January 28 will result in an unleased tract, and the tract will be subject to the requirements for leasing an unleased tract under ARM 36.25.115.

(2) A cabinsite lease is not subject to bids upon renewal if the lessee continues the lease and the lessee has paid all rentals and the lease is in good standing. The lease shall be renewed at the rental according to 36.25.1003.

36.25.1012 CABINSITE HARDSHIP RENTAL DEFERMENT

(1) A cabinsite lessee may request a deferment for a portion of the lease payment. Such deferment will be a 25 percent reduction of the lease payment. An eligible lessee may obtain an annual lease deferment for a maximum of three years.

(2) To qualify for a deferment, a lessee must:

(a) use the cabinsite for his/her primary residence; and

(b) have an annual household income at or below 80 percent of the most current Area Median Income (AMI) limit published by the Montana Department of Commerce.

(3) A lessee seeking the hardship rental deferment shall submit an application on a form prescribed by the department prior to October 1 annually, to qualify for the next billing cycle.

(4) Verification of eligibility will occur on an annual basis. If a lessee is determined eligible, the deferment may occur in the lease year the lessee was determined to be eligible, though the department will not issue any refund of payment, only credit for future payments.

(5) If the three-year hardship period ends, or the lessee no longer meets the eligibility criteria at the time of annual reverification, then the deferred payments must be made in one of the following ways:

(a) at assignment, as a condition of assignment;

(b) as a balloon payment made in association with paying a regular lease payment as billed by the department during the three-year hardship period; or

(c) paid back over a four-year period at the end of the three-year hardship period. The amount of lease payment deferral would be tabulated, with interest thereon at the rate of return of the unified investment program administered by the board of investments pursuant to 17-6-201, MCA, then divided by four. The resulting amount would be added to each annual payment over a four year period until the deferred rental was repaid.

36.25.1013 ADMINISTRATIVE HEARINGS RELATED TO CABINSITE LEASE DISPUTES

(1) Any cabinsite lessee may request a hearing before the department to resolve any dispute which arises from the interpretation of, the administration of, the cancellation of, or the rental due upon, a cabinsite lease. However, the department shall not provide for any hearing upon the assessed valuations determined by the DOR for any cabinsite under 15-7-111, MCA.